Federal Appeals Court Interprets Section 16(b)'s Short-Swing Profits Rule Not Applicable to Trades Between Different Types of Equity Securities

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Last week, the United States Court of Appeals for the Second Circuit (the "Second Circuit") held that, in certain situations, company insiders are not subject to short-swing profit disgorgement under the Securities Exchange Act of 1934 (the "Exchange Act") for trades made between different types of equity securities in the same company.

Section 16(b) of the Exchange Act provides for the disgorgement of profits by company insiders[1] realized "from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months," unless an exception applies. This provision is often referred to as the "short-swing profit rule," whereby an insider's non-exempt transactions are "paired" against one another in order to determine an insider's short-swing liability. The rule was created for the purpose of preventing the unfair use of information which may have been obtained by an insider by virtue of its relationship with an issuer and, absent an exception, applies to all insiders regardless of whether the insider is actually privy to any such information.

In Gibbons v. Malone, No. 11-3620-cv, 2013 WL 57844 (2nd Cir. January 7, 2013), the defendant, a director and large shareholder of Discovery Communications, Inc. ("Discovery"), engaged in a series of nine sales of Discovery's "Series C" stock and ten purchases of Discovery's "Series A" stock during a two-week period in December of 2008. The plaintiff alleged that this series of sales and purchases violated Section 16(b)'s short-swing profit rule and that the defendant obtained "illicit profits in the amount of $313,573" as a result of these trades.

The Second Circuit affirmed the lower district court's dismissal of the plaintiff's claim and held that the purchase of one equity security and the sale of a *different* equity security issued by the same company could not be "paired" under Section 16(b)'s short-swing profit rule. The court's conclusion was supported by the fact that Congress' use of the singular term "any equity security" versus "any equity securities" in Section 16(b)

[1] Includes officers, directors and beneficial owners of greater than 10% of any class of equity security of the issuer that is registered under the Exchange Act.

implied that the short-swing profit rule was meant to apply only in trades of one type of equity security and not among trades of various securities registered by the issuer.

The court's decision rested on the determination that the securities traded by the plaintiff were not "economically equivalent," but rather were separate and distinct from one another[2] due to their (i) different voting rights, (ii) separate trading markets with independent fluctuating prices and (iii) nonconvertible nature.

While the court's holding is relatively narrow in providing clear exemption only for insiders who trade equity securities in two or more separately traded securities that are nonconvertible with separate voting rights, the application of the holding still has broad application to many companies and relaxes the otherwise strict rule found in Section 16(b).

GableGotwals advises corporations and master limited partnerships on Securities and Exchange Commission, NASDAQ and NYSE reporting and compliance. If you have any questions regarding this article, please contact Richard M. Carson or Brandon M. Watson at 918-595-4800.

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[2] The court stated that, "[t]hough we do not decide the issue here, we note that §16(b) could apply to transactions where the securities at issue are not meaningfully distinguishable."