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Alert Memo

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The Second Circuit Holds the Short-Swing Profit Rule Inapplicable to Insider's Purchase and Sale of Different Types of Stock in the Same Company

On January 7, 2013, the Second Circuit Court of Appeals ruled that Section 16(b) of the Securities Exchange Act of 1934, which provides for the disgorgement of profits that corporate insiders realize "from any purchase and sale, or any sale and purchase, of any equity security" of the corporate issuer within any period of less than six months (the "short-swing profit rule"), does not apply to a corporate insider's purchase and sale of shares of different types of stock in the same company where those securities are separately traded, nonconvertible stocks that have different voting rights. Gibbons v. Malone, No. 11 Civ. 3620, 2013 U.S. App. LEXIS 398 (2d Cir. Jan. 7, 2013). Throughout its analysis, the court characterized § 16(b) as a blunt, mechanical rule that prioritizes ease of enforcement over maximum deterrence. Acknowledging the policy reasons for a more flexible interpretation of the rule, the Second Circuit invited the SEC to consider interpreting the short-swing profit rule to cover "similar" equity securities.

The facts in Gibbons were straightforward. Between December 4 and December 17, 2008, defendant John Malone, a director and major shareholder of Discovery Communications, Inc., sold 953,506 shares of Discovery's Series C stock and purchased 632,700 shares of Series A stock. Series A and Series C are separately registered, separately traded nonconvertible securities. Series A holders have voting rights, while Series C holders do not. Mr. Gibbons, a Discovery shareholder, filed suit under 15 U.S.C. § 78p(b)[1] seeking disgorgement of Mr. Malone's profits from the transactions.

The District Court for the Southern District of New York dismissed the complaint for failure to state a claim under § 16(b). Gibbons v. Malone, 801 F. Supp. 2d 243 (S.DN.Y. 2011). District Judge Jones explained that the term "any equity security" was singular and as such the statute did not apply to transactions in multiple securities. She further noted that, unlike other financial instruments that are treated as "functionally equivalent" under § 16(b), Series A and Series C stock are not convertible and do not have a fixed value relative to each other. Finally, Judge Jones rejected the policy argument that "[p]ermitting short-swing trading between voting and non-voting stock would make evasion

[1] 15 U.S.C. § 78p(b) allows the "owner of any security of the issuer" to sue for disgorgement "if the issuer shall fail or refuse to bring suit." Gibbons made a pre-suit demand that Discovery rejected.

of Section 16 trivially easy" on the grounds that § 16(b) has been widely recognized as a "bright-line rule" that was "specifically designed by Congress for easy application."

The Second Circuit affirmed the District Court's ruling. The key issue for the Court of Appeals was whether the sale of one security and the purchase of a different security issued by the same company can be "paired" under § 16(b).[2] In considering this issue, notably, the court first observed that § 16(b) is a statute of strict liability, requiring no proof that the insider intended to profit from the use of inside information. The court went on to agree with the District Court that, as a matter of textual interpretation, the use of the singular in the term "any equity security" means that transactions involving different equity securities cannot be paired under § 16(b). The provision thus applies only to the purchase and sale of "the same equity security."[3]

The Second Circuit next noted, without deciding, that § 16(b) might be interpreted to permit the pairing of transactions in equity securities that "are not meaningfully distinguishable." The court highlighted the fungibility of shares of stock and expressed reluctance to differentiate securities based solely on "corporate labels." Moreover, in its view, "[r]ecognizing the equivalence of essentially indistinguishable securities would also comport with the purpose of the short-swing profit rule" because "when two types of stock are not meaningfully different, the risk of short-swing speculation is likely to be much higher than when those stocks are distinguishable, because shareholders would typically have little reason to convert holdings of one type of stock into holdings of another type that is effectively the same." But the securities at issue in Gibbons were "readily distinguishable" to the Second Circuit because only Series A shares confer voting rights, which could provide a meaningful economic reason for shareholders to prefer one series over the other. Nor were these nonconvertible securities whose prices fluctuated relative to one other "economically equivalent."

Finally, the Second Circuit refrained from considering whether the two securities were sufficiently "similar" to be paired under § 16(b). Although the court allowed the plausibility of this interpretation, it declined to adopt a standard-based approach absent SEC direction and indeed expressed skepticism that a "similarity" test would be consistent with the language and purpose of § 16(b). Echoing the District Court, the Second Circuit noted that § 16(b) was meant to be "simple" and to create "mechanical requirements" so that it would be "capable of easy administration."

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[2] As the court explained, "'if the conversion can be paired with another 'sale' or purchase,' and the paired transactions occur within a six month period, the paired transactions are . . . the type of insider activity that Section 16(b) was designed to prevent,' Blau v. Lamb, 363 F.2d 507, 517 (2d Cir. 1966), but transactions of securities that cannot be 'paired' are not within the scope of § 16(b)."

[3] See also, e.g., Smolowe v. Delendo Corp., 136 F.2d 231, 237 n.13 (2d Cir. 1943) (likelihood "that Congress intended [§ 16(b) to permit recovery where stock of one class is purchased and another class sold] is beyond the realm of judicial fantasy").

The court concluded by mentioning, but not resolving, whether convertibility between financial instruments might be a sufficient condition to make those instruments matching securities under § 16(b).[4]

Gibbons highlights the tension between two Congressional purposes in enacting § 16(b): ease of administration and deterrence of insider abuse. The Second Circuit repeatedly pointed out the policy rationales in favor of a more flexible approach to the short-swing profit rule but declined to adopt such an interpretation "absent SEC direction" and in the face of the long-standing policy rationale for a simple, mechanical short-swing profit rule. The tenor of Gibbons suggests that the Second Circuit would welcome SEC guidance on the application of § 16(b) in the future.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "White-Collar Defense, Securities Enforcement and Internal Investigations" in the "Practices" section of our website (www.clearygottlieb.com).

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[4] The Eleventh Circuit appeared to so hold in Gund v. First Florida Banks, Inc., 726 F.2d 682 (11th Cir. 1984).

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