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ALERT MEMORANDUM

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COURTS CONSIDER THE EFFICACY OF SECTION 16 BLOCKER PROVISIONS IN CONVERTIBLE INSTRUMENTS

In two unrelated cases that turned on the efficacy of "blocker provisions" or "conversion caps" for purposes of Section 16 of the Securities Exchange Act of 1934, as amended (the "Act"), the U.S. District Court for the Southern District of New York ruled against defendants seeking to dismiss plaintiffs' claims for disgorgement of short-swing profits. The rulings are consistent with prior caselaw concerning such provisions, and confirm the efficacy of such provisions in general, but also highlight contexts in which caution should be exercised.

Section 16 imposes reporting requirements on "statutory insiders," including 10% shareholders, of public companies (other than foreign private issuers), and requires statutory insiders to disgorge profits earned through purchases and sales of equity securities within six months. For these purposes, 10%-shareholder status is based on the beneficial ownership principles of Section 13(d) of the Act. Those principles provide, generally, that persons are deemed to beneficially own securities they have the right to acquire within 60 days. Investors who may become 10% shareholders by virtue of their ownership of convertible debt or other rights to acquire stock sometimes seek to avoid statutory insider status by contractually prohibiting conversion or exercise to the extent that it would result in the insider becoming a 10% shareholder.

The effectiveness of such blocker provisions was addressed in detail in an amicus brief filed by the Securities and Exchange Commission (the "SEC") with the Second Circuit Court of Appeals in the case of *Levy v. Southbrook,*[1] and in the Second Circuit's decision in that case.[2] In sum, the SEC's brief focuses on:

1. the validity of a blocker provision - i.e., essentially, whether it would be fully respected as a matter of contract law;

2. whether a blocker provision is effective to avoid incremental ownership in light of the meaning of the term "beneficial owner" for purposes of Section 13(d) – i.e., essentially, whether a person's right to successively acquire and immediately dispose of stock would be considered not to give rise to beneficial ownership because at no instant in time could the person actually hold stock in excess of the blocker's threshold; and

3. whether a blocker agreement may be "illusory" or a "sham" – i.e., essentially, whether a blocker is a mechanism for technically divesting a person of the apparent right to acquire underlying shares without in reality affecting that person's ability to acquire the stock.

[1] http://www.sec.gov/litigation/briefs/2001/levy0301.pdf.
[2] *Levy v. Southbrook International Investments, Ltd*, 263 F.3d 10 (2001).

The SEC concludes that blocker provisions can be valid and effective to avoid incremental beneficial ownership and, depending on the facts and circumstances, not illusory.[3]

The Court of Appeals' decision in *Southbrook* accepted the SEC's position. In addition, the Court concluded that the blocker provision in *Southbrook* was not a sham, notwithstanding an ambiguity in the language that the plaintiff argued evidenced the illusory nature of the arrangement. Specifically, the blocker provision provided that the holder "may . . . revoke" a conversion or exercise in order to stay under Section 13(d)'s 5% beneficial owner limit. The Court interpreted the provision to mean that the holder *would not be permitted* to convert or exercise if the conversion or exercise would result in the holder exceeding that limit, based on the entirety of the provision and the apparent intention of the parties.[4]

1. Blockers and Groups

The first of the two recent cases, *Greenberg v Hudson Bay Master Fund Ltd*,[5] involves a claim against two hedge funds that were alleged to have formed a group with each other and with other non-defendant persons. Neither of the hedge funds was, by itself (including its affiliates), a Section 13(d) beneficial owner of more than 10% of a registered class of voting equity securities of the issuer, WPCS International Inc. While the hedge funds asserted a number of defenses, none of which were successful, the most notable of its arguments relied on blocker provisions in convertible notes and warrants that were central to whether they were 10% shareholders. The blocker provision in the convertible notes, and a similar provision in the warrants, stated that:

[3] The SEC's amicus brief states that "while we take no position on the validity of the conversion cap in this case, we believe that such provisions must be examined on a case-by-case basis to determine whether they are binding and valid. Factors that may indicate that a conversion cap is illusory include whether the cap: is easily waivable by the parties (particularly the holder of the convertible securities); lacks an enforcement mechanism; has not been adhered to in practice; or can be avoided by transferring the securities to an affiliate of the holder. Factors that may indicate that a cap is binding include whether it is provided in the certificate of designation or the issuer's governing instruments; reflects limitations established by another regulatory scheme applicable to the issuer; or is the product of bona fide negotiations between the parties. Limitations on the number of conversions that may take place over a period of time may add integrity to such provisions, although they are not essential. When the limitations provided by conversion caps are discovered to be illusory or a sham, they should be disregarded and the courts should analyze the case as though no such limitations existed."

[4] The blocker provision in *Southbrook* stated: "The Purchaser may not use its ability to convert Shares hereunder or under the terms of the Vote Certificates or to exercise its right to acquire shares of common stock under the Warrants to the extent that such conversion or exercise would result in the Purchaser owning more than 4.9% of the outstanding shares of the Common Stock. The company shall, promptly upon its receipt of a Holder Conversion Notice tendered by the Purchaser (or its sole designee) under the Vote Certificates, and upon its receipt of a notice of exercise under the terms of any of the Warrants, notify the Purchaser by telephone and by facsimile of the number of shares of Common Stock outstanding on such date and the number of Underlying Shares and Warrant Shares which would be issuable to the Purchaser (or its sole designee, as the case may be) if the conversion requested in such Conversion Notice or exercise requested in such exercise notice were effected in full, whereupon, notwithstanding anything to the contrary set forth in the Vote Certificates or the Warrants, the Purchaser may within one Trading Day of its receipt of the Company notice required by this Section by telephone or by facsimile revoke such conversion or exercise to the extent that it determines that such conversion or exercise would result in the Purchaser owning in excess of 4.9% of such outstanding shares of Common Stock."

[5] *Greenberg v. Hudson Bay Master Fund Ltd*, No. 14cv5226 (SDNY 2015).

> Notwithstanding anything to the contrary contained in this Note, this Note shall not be exercisable by the Holder hereof, and [WPCS] shall not effect any conversion . . . to the extent (but only to the extent) that giving effect to such conversion or other share issuance hereunder the Holder (together with its affiliates) would beneficially own in excess of 9.99% . . . of the Common Stock. . . . For purposes of this paragraph, beneficial ownership . . . shall be determined in accordance with Section 13(d).

The Court effectively held that the provision contains a flaw, in that the phrase "Holder (together with its affiliates) would beneficially own in excess of 9.99%" does not refer to members of a group of which the Holder may be a part.[6] While we think the language of the blocker was adequate to reflect the intention of the parties, and did cover the group context through its reference to beneficial ownership being determined under Section 13(d), the defendants appear to have made these arguments and the Court clearly disagreed. An explicit reference in the blocker provision to groups that include the holder should eliminate this drafting issue.

The Court goes on, however, to raise the question, albeit in dicta (i.e., a view that does not appear to have been relied on for its disposition of the case), of whether blockers may be inherently less reliable in the context of a holder who is part of a group because the mechanism for enforcing the blocker is arguably more difficult in that context than in the context of a holder who is not part of a group. In particular, the Court states that:

> the Defendants admit that WPCS did not view them as a group. They do not explain, therefore, how WPCS could have acted to enforce the conversion caps that explicitly operated vis-à-vis individual shareholders in the group that the plaintiff alleges existed here.

This concern about enforceability is hard to square with the Court of Appeals' apparent reliance in *Southbrook* on a self-policing mechanism.[7] Although the issuer was required on receipt of a conversion notice to provide the holder with the total number of outstanding shares and the number that would be issued pursuant to that notice, it is left to the holder to revoke the conversion notice to stay below the cap. In light of the lower court's approach in *Greenberg*, however, a holder relying on the cap in a group context should ensure that it has the information necessary to self-police compliance with its contractual agreement not to acquire beneficial ownership in excess of the applicable limit. Depending on the context, it might also be prudent to require the holder, as part of the conversion exercise process, to certify that a proposed conversion complies with the limitations imposed by the applicable cap.

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[6] "Both the Notes and the Warrants contain a conversion cap. While this conversion cap is binding on a single shareholder, it does not shield a shareholder from liability when that shareholder acts as a part of a group. Each individual shareholder has no 'right' to convert shares in excess of the cap, but by acting as a group shareholders may acquire shares in excess of the caps on each shareholder's rights."

[7] The same concern would seem to also exist in the context of holders who are not part of a group, when an issuer's attempt to police compliance with the cap would necessarily rely on information concerning other beneficial ownership by the holder and its affiliates (even if not on the beneficial ownership of members of a group of which the holder is a member). Nevertheless, in the context of a holder that is not part of a group, and in the absence of other facts suggesting that the blocker provision may be illusory (see the discussion below), enforceability is less likely to be an independent concern once the blocker provision is established to be valid and binding based on *Southbrook*.

2. Adding a Blocker

The second of the cases, *Roth v Solus Alternative Asset Management LP*,[8] involves a claim based on the ineffectiveness of a conversion cap that was added to a convertible note after the note had been acquired by the purported 10% shareholder. The Court denied defendant's motion to dismiss, holding that the plaintiff should be given an opportunity to present facts supporting the argument that the cap was illusory.

Notably, the Court explicitly stopped short of concluding that a conversion cap put in place with a person who is already a 10% shareholder is necessarily invalid: "Solus' status as an insider at the time it executed the Blocker Provision is not dispositive." However, the Court seemed to believe this fact is material to the question whether the conversion cap is illusory and therefore ineffective:

> Solus argues that its Blocker Provision amounts to a routine conversion cap similar to ones which courts have upheld. But the Blocker Provision here is not really a 'blocker' (or 'cap') at all. It is a one-time divestment mechanism: its sole purpose is to divest Solus of beneficial ownership of a block of securities. . . . As such, rather than *preventing* Solus from attaining insider status . . . the Blocker Provision purports to *eliminate* it."

By contrast with the *Greenberg* ruling, the holding in *Solus* is clearly a function of the facts and circumstances question whether the conversion cap was illusory, an attempt to make it appear that there was a real limitation on the defendant's right to convert when in reality there was not. The Court states that whether the cap was illusory is largely a question of the intent of the parties. The Court appears specifically to have been motivated by the fact that the conversion cap in *Solus* was added in the context of a recapitalization of the issuer, in which context the Court saw the cap as potentially an inappropriate means to address the very near-term risk of short swing profit disgorgement arising from transactions that were at the time actually being contemplated. That plausible reading suggests, obviously, that practitioners should be particularly careful about relying on caps in similar circumstances.

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 "Capital Markets" under the "Practices" section of our website at http://www.clearygottlieb.com.

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[8] *Roth v Solus Alternative Asset Management LP,* No. 14cv9571 (SDNY 2015).

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