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Second Circuit Dismisses Short-Swing Profit Claim

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In a case of first impression, the Second Circuit in *Gibbons v. Malone*, No. 11–3620–cv, 2013 WL 57844 (2d Cir. Jan. 7, 2013) declined to apply Section 16(b) of the Securities Exchange Act of 1934, more commonly known as the "short-swing profit rule," to a corporate insider transaction involving shares of two different classes of stock of the same issuer. By doing so, the Second Circuit signaled that, absent any SEC guidance to the contrary, it would strictly adhere to the statutory text of the federal securities laws. The decision also sheds light on what security transactions will fall within the statute's purview.

Section 16(b) was designed to prevent insiders from profiting through the use of material non-public information when trading in a company's securities. The relevant text of the statute provides as follows:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him 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 . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction . . . . (emphasis added).

In other words, the statute provides for the disgorgement of profits that corporate insiders realize from any paired purchase and/or sale of any equity security of the issuer that occurs within less than six months.

John Malone, the defendant in *Gibbons*, was a director and large shareholder in Discovery Communications, Inc. Over a roughly two-week period, Malone made nine sales of Discovery "Series C" stock totaling 953,506 shares and ten purchases of Discovery "Series A" stock totaling 632,700 shares. The Series A and Series C stock were separately registered and traded on the NASDAQ stock exchange. The Series A stock came with voting rights while the Series C stock did not offer voting rights. Neither series was convertible into the other. Malone allegedly reaped profits of at least $313,573 from the sales and purchases.[1] The plaintiff, a shareholder in the corporation, sued Malone under Section 16(b) seeking disgorgement of the alleged illicit profits from the transactions. The District Court dismissed plaintiff's case for failure to state a claim.

The Second Circuit affirmed. First, the Second Circuit noted that only securities transactions that can be "paired" fall within the scope of Rule 16(b). Accordingly, the Second Circuit stated that the "question presented is whether a sale of one security and a purchase of a different security issued by the same company can be 'paired' under § 16(b)." Examining the statute's language, the Court determined that "use of the singular term 'any equity security' supports an inference that transactions involving *different* equity securities cannot be paired under § 16(b)." In doing so, the Court rejected the plaintiff's contention that the use of the word "any" broadened the scope of the statute to include different paired securities.[2]

Second, the Court declined to accept plaintiff's argument that the Series A stock and Series C stock were the same security because they were "economically equivalent." While the Court agreed that Section 16(b) "could apply to transactions where the securities at issue are not meaningfully distinguishable," it found that the Series A and Series C stock were "readily distinguishable" because of the voting rights that attached to the Series A stock. The Court reasoned the voting rights could lead an insider to "prefer one security over the other for reasons not related to short-swing profits." The Court also explained that the "economic equivalence" principle was a creature of fixed-ratio convertible instruments, where courts considered whether exercising a conversion right constituted a purchase or sale under Section 16(b).[3]

Third, the Court considered the plaintiff's contention that, even if the securities were not economically equivalent, they were "sufficiently similar" to fall within Section 16(b). The Court stated that "a straightforward reading of the text" precluded an interpretation of similarity rather than sameness. The Court also noted, citing a Supreme Court case, that Congress intended Section 16(b) to be a mechanical, simple rule in its application. Using a litmus test of "similarity" would undermine this purpose and make Section 16(b) difficult to administer going forward.[4]

The *Gibbons* decision has a number of important ramifications. Most critically, the decision clarifies the scope of Section 16(b) liability by refusing to extend its reach to different types of stock in the same company that are "meaningfully distinguishable." In this context, so long as an insider can demonstrate that the securities he or she is transacting "are distinct not merely in name but also in substance," Section 16(b) liability should not attach.[5] Moreover, the opinion suggests that in the securities arena, the Second Circuit will not apply its own interpretive gloss to the securities laws "absent SEC direction."[6] Indeed, while the Second Circuit indicated a willingness to consider SEC guidance in interpreting Section 16(b), the Court declined the plaintiff's invitation to venture on its own beyond the plain language of the statute.

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[1] *Gibbons v. Malone*, 2013 WL 57844, at *1.

[2] *Id*. at *3.

[3] *Id*. at *4-*5. Notably, the Court observed that the SEC had interpreted Section 16(b) to include equity securities with a fixed-ratio conversion feature but not securities with an exercise or conversion privilege at a price that is not fixed. Since the securities purchased by Malone were not convertible, the Court concluded that "the SEC rules are of no help to [plaintiff's] argument and merely reinforce our conclusion that the Series A stock and Series C stock cannot be paired under § 16(b)."

[4] *Id*. at *5-*6.

[5] *Id*. at *4.

[6] *Id*. at *5.