Securities Regulatory UPDATE

INDUSTRY VIEWS ON RECENT RULEMAKING AND LEGISLATION

VOLUME 6, ISSUE 22 NOVEMBER 24, 2003

Supreme Court Lets Stand Controversial Section 16(b) Ruling

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Insiders of publicly traded companies could face shareholder lawsuits following the U.S. Supreme Court's decision on October 14, 2003 not to review the controversial ruling of the U.S. Court of Appeals for the Third Circuit in *Levy vs. Sterling Holding Company, LLC, National Semiconductor Corporation and Fairchild Semiconductor International, Inc.*

In the *Levy* case, the Third Circuit severely restricted the scope and applicability of at least two, and likely three, exemptions from the Section 16(b) short-swing profit recovery rules adopted under the Securities Exchange Act of 1934. The decision is highly controversial because it is directly at odds with the views of the Securities and Exchange Commission and the decisions of other U.S. Circuit Courts.

Section 16(b)

Section 16(b) requires that any profits earned by insiders through "short-swing" trading in an issuer's equity securities must be disgorged and returned to the issuer. Short-swing trading is the purchase and sale, or sale and purchase, of an issuer's equity securities within any period of less than six months. Congress' purpose in enacting Section 16(b) was to prevent insiders of public companies (namely officers, directors and 10% shareholders), who are assumed to have inside information, from profiting on trades in the issuer's equity securities over a short time frame. Because Section 16(b) imposes liability without fault, Congress granted the SEC authority to exempt certain transactions from Section 16(b). The three exemptions from Section 16(b) which are at issue in the *Levy* case are Rule 16b-7, Rule 16b-3(d) and Rule 16b-3(e).

Relevant Section 16(b) Exemptions

Rule 16b-7. Rule 16b-7, which is titled "Mergers, Reclassifications and Consolidations," exempts mergers and consolidations from Section 16(b) where the transaction in question involves an issuer that owns at least 85% of another issuer. These transactions have typically been deemed not to involve a significant change in the character of the issuer and, thus, are of minor significance to its stockholders. Although reclassifications are never mentioned in the text of the rule, the SEC and other pre-*Levy* decisions have held that reclassifications are exempt under Rule 16b-7. Reclassifications are common transactions immediately prior to or in connection with an initial public offering, as was the fact pattern in the *Levy* case.

Rule 16b-3(d). Rule 16b-3(d) exempts from Section 16(b) grants, awards and other acquisitions of equity securities from the issuer if (i) the transaction is approved by the issuer's board of directors or a committee of the board composed solely of two or more non-employee directors, (ii) the transaction is approved

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or ratified by the stockholders of the issuer or (iii) the equity securities acquired are held by the insider for at least six months. Rule 16b-3(d) is widely used by insiders to exempt various forms of transactions, such as grants of options and restricted stock and the receipt of stock in connection with reclassifications and non-Rule 16b-7 mergers.

Rule 16b-3(e). Rule 16b-3(e) exempts from Section 16(b) the disposition to the issuer of the issuer's equity securities if (i) the transaction is approved by the issuer's board of directors or a committee of the board composed solely of two or more non-employee directors or (ii) the transaction is approved or ratified by the stockholders of the issuer. Rule 16b-3(e), like Rule 16b-3(d), is widely used by insiders to exempt various forms of transactions, such as dispositions of securities in connection with reclassifications and non-Rule 16b-7 mergers.

The [Levy] decision is highly controversial because it is directly at odds with the views of the Securities and Exchange Commission and the decisions of other U.S. Circuit Courts.

Levy Case

Facts. Levy alleged that Sterling Holding Company, LLC and National Semiconductor Corporation made short-swing trading profits of approximately $72 million in Fairchild Semiconductor International, Inc. Both Sterling and National were, at all relevant times, insiders of Fairchild because of their ownership of greater than 10% of the common and preferred stock of Fairchild.

In July 1999, in contemplation of the August 1999 initial public offering of Fairchild, Fairchild's stockholders approved a reclassification pursuant to which all outstanding Fairchild preferred stock would automatically be converted into Fairchild common stock upon the completion of the IPO. As a result, upon completion of the IPO, Sterling and National's shares of Fairchild preferred stock were converted into shares of Fairchild common stock. In January 2000, within six months of the completion of the IPO, Sterling and National sold shares of common stock of Fairchild for a profit of approximately $72 million.

Levy, a shareholder of Fairchild, brought a shareholder derivative suit in U.S. District Court for the District of Delaware alleging that the August 1999 receipt by Sterling and National of Fairchild common stock in the reclassification was a Section 16(b) purchase and, thus, should be matched with the January 2000 sale, which occurred within a six-month time frame. The District Court dismissed the case for failure to state a claim because Rule 16b-7 exempted the reclassification transaction. Levy then appealed to the Third Circuit.

The key issue relates to whether the August 1999 reclassification is exempt from Section 16(b).

Levy Argument. Levy alleged that the August 1999 reclassification was not exempt from Section 16(b). Levy alleged that Rule 16b-7 is inapplicable because (i) the rule does not apply to all reclassifications and (ii) the Fairchild reclassification was not of minor significance to the stockholders of Fairchild because the reclassification involved a change in class of stock and the proportionate interests of Fairchild's stockholders changed as a result of the reclassification. Levy also alleged that Rule 16b-3(d) is inapplicable because it is only applicable to transactions that contain some element of compensation.

Sterling and National Argument. Sterling and National argued that both Rules 16b-7 and 16b-3(d) applied to the August 1999 reclassification transaction. Sterling and National argued that Rule 16b-7 applied to reclassifications because the term is used in the title of the rule. In addition, they argued that an SEC interpretive release issued soon after the adoption of Rule 16b-7 and language contained in a 2002 SEC proposed rule expressed the SEC's view that reclassifications were covered by the provision. Finally, Sterling and National argued that Rule 16b-7 exempts transactions involving at least 85% cross-ownership and reclassifications, which are an exchange of securities of the same company involving, in effect, 100% cross-ownership.

Sterling and National also argued that the language of Rule 16b-3(d) is applicable because the

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reclassification was approved by Fairchild's board and a majority of its stockholders. In addition, Sterling and National noted that, in its 1996 release adopting Rule 16b-3, the SEC stated that a transaction exempted under the rule "need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element" (emphasis added).

Third Circuit Decision. The Third Circuit agreed with Levy on substantially all of Levy's arguments. The court held that Rule 16b-7 was inapplicable because, while Rule 16b-7 is applicable to some, but not all, reclassifications, the Fairchild reclassification was not of minor significance to the stockholders of Fairchild. More importantly, the court found Rule 16b-3(d) inapplicable because there was no compensatory element to the August 1999 reclassification transaction. The court was convinced that, based on the language of the 1996 adopting release, Rule 16b-3 primarily is concerned with employee benefit plans. In addition, the court determined that, while the adopting release provides that the transaction need not specifically have a compensatory element, it must have "some connection to a compensation-related function." Therefore, the Third Circuit reversed the District Court's dismissal and remanded the case to the District Court for further proceedings.

Following the Third Circuit decision, the SEC submitted an amicus brief in connection with a motion for rehearing submitted by Sterling and National. In the brief, the SEC agreed with substantially all of the arguments raised by Sterling and National with respect to the applicability of both Rule 16b-3(d) and 16b-7. However, the Third Circuit denied the motion for rehearing.

Analysis and Practical Advice

The Third Circuit decision, which is at odds with decisions rendered by the Second Circuit, could result in many shareholder suits related to transactions that have already occurred (until the two-year statute of limitations period expires) because the Third Circuit includes Delaware, where many public companies are organized. The primary types of transactions that will be affected by the decision are reclassifications, mergers that do not meet the Rule 16b-7 exemption and sales of equity securities to the issuer in exchange for other forms of equity securities.

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Although it is possible that the SEC will adopt amendments to Rules 16b-3 and 16b-7 to negate the effects of the Third Circuit decision, the SEC has not yet commenced any rulemaking action. Until such time as the SEC takes further action, insiders and issuers should consider the following:

- If an issuer intends to engage in a transaction that could be covered by the *Levy* decision, the issuer should advise its insiders to avoid any transactions within six months of such transaction that would result in short-swing liability.
- Although the Third Circuit made no mention of Rule 16b-3(e) in its ruling, it is likely that the Third Circuit would find that transactions under this rule, which covers dispositions of securities to the issuer, would also need to have a compensatory element.
- Most agreements for non-Rule 16b-7 mergers contain covenants requiring both the acquiring company and the target company to take all actions necessary to ensure that the acquisition and disposition of securities in the merger is exempt under Rule 16b-3. Issuers need to carefully consider their ability to comply with this covenant in light of the *Levy* decision.
- Acquiring companies that intend to appoint officers or directors of the target company as officers or directors of the acquiring company following a non-Rule 16b-7 merger should consider having such persons take office on the day *following* the merger, rather than at the effective time of the merger. In this

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event, the person will not be an insider of the acquiring company at the time of the person's acquisition of the acquiring company's securities. Therefore, the acquisition of the securities in the merger will not be a Section 16(b) purchase.

• Consider adding language to board resolutions approving the types of transactions that could be covered by the *Levy* decision that would include a compensatory purpose for the transaction. However, the addition of compensatory language could have negative accounting or tax consequences to the issuer or its insiders and, thus, issuers should consult with their auditors and tax counsel before taking any such action. ■

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