

Second Circuit Finds No Liability Under Short-Swing Profit Rules for "Pairing" Transactions That Relate to Two Different Classes of Equity Securities

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The Second Circuit recently issued a decision that relates to whether a sale of one class of equity security and a purchase of a different class of equity security issued by the same company can be “paired” under Section 16(b) of the Exchange Act to result in required profit disgorgement by the transacting insider. The Court held that, absent any guidance from the SEC, an insider’s purchase and sale of shares of different types of stock in the same company does not trigger liability under Section 16(b) where those different classes of securities are separately traded, nonconvertible and have different voting rights.

Section 16(b) provides for the disgorgement of any profit realized by an issuer insider (including a greater than 10% beneficial owner of the issuer, an officer or a director of issuer, each as defined under the Section 16 rules) from any purchase and sale, or any sale and purchase, of any equity security of the issuer within a period of less than six months. Between December 4, 2008 and December 17, 2008, John Malone, a director and large shareholder of Discovery Communications, engaged in 9 sales of Series C stock and 10 purchases of Series A stock. The two classes of equity securities are separately registered and traded (with different ticker symbols on NASDAQ) and they are not convertible into each other. Series A has voting rights while Series C does not. In addition, during 2008 and 2009, Series A generally, though not always, traded at slightly higher prices than Series C.

In upholding the lower court’s decision, the Second Circuit relied largely on a plain reading of Section 16(b)’s use of the singular term “any equity security,” which supports an inference that transactions involving different equity securities cannot be paired. The Court noted, however, that Section 16(b) could apply to transactions where different classes of securities are not meaningfully distinguishable. Here, the Court distinguished the two classes of securities because they have different voting rights, are not convertible into each other and do not have a fixed value relative to each other.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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