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SEC/CORPORATE

Court Provides Clarification on Short Swing Profit Rules

The U.S. District Court for the Southern District of New York dismissed a claim brought under Section 16(b) of the Securities and Exchange Act of 1934, finding that the sale and purchase within six months of two different series of common stock traded under different ticker symbols and not otherwise convertible into one another or derivatives of one another did not constitute the "purchase and sale, or any sale and purchase, of any equity security" under Section 16(b) of the Exchange Act.

Plaintiff Michael Gibbons brought suit under Section 16(b) of the Exchange Act against John Malone and Discovery Communications, Inc. alleging that Malone, a former director of Discovery, engaged in insider trading by selling shares of Discovery's Series C Common Stock and separately purchasing shares of Discovery's Series A Common Stock during a two week period in December 2008. The plaintiff alleged that "for each share of Series A Stock purchased by Malone, a corresponding sale of Series C Stock was made at a higher price by Malone." Gibbons sought disgorgement of Malone's short swing profit.

The defendants, in their motion to dismiss for failure to state a claim upon which relief could be granted, argued that transactions in different series of stock were not subject to disgorgement of profits under Section 16(b). The court ultimately agreed and dismissed the claim. In so holding, the court made the following findings:

- The plain language of Section 16(b) requires that the purchase and sale be of the same equity security. The court noted that, while courts had previously held that the sale of a derivative of another security or securities convertible into each other or another security would constitute the sale of the same equity security, the securities at issue in this matter did not fall within any of the foregoing classifications.

- A high correlation or similarity in price is insufficient to establish that the two different series of securities should be treated as the same equity security for Section 16(b) purposes.

- Where, as here, two series of common stock have sufficiently different rights, they should not be considered part of the same class of equity security for Section 16(b) purposes. Notably, the series at issue in this matter had different voting and stock dividend rights, were not convertible into the other, were traded under different ticker symbols and the prices were not fixed such that they did not gain or lose value in unison.

- Plaintiff's policy argument that "[p]ermitting short-swing trading between voting and non-voting common stock would make evasion of Section 16 trivially easy" was not a sufficient policy argument to blur the "bright-line rule" established by Section 16(b).

Michael D. Gibbons v. John C. Malone and Discovery Communications, Inc., No. 10 Civ. 8640 (BSJ) (S.D.N.Y. August 8, 2011).

Click here to read the Memorandum and Order.

BROKER DEALER

Application of SEC's Financial Responsibility Rules in Response to Standard & Poor's Downgrade of U.S. Long-Term Credit Rating

On August 5, the Financial Industry Regulatory Authority, Inc. issued Regulatory Notice 11-38 in response to the downgrade of the U.S. long-term credit rating by Standard & Poor's. The notice provides guidance to member firms on the application of the Securities and Exchange Commission's Net Capital and Customer Protection Rules to U.S. Treasury securities and other securities issued, or guaranteed as to principal and interest, by the U.S. or any of its governmental agencies. The issuance of the rating downgrade does not alter the fact that under Rule 15c3-1 of the Securities Exchange Act of 1934, the credit rating assigned to U.S. Treasury securities or other securities issued, or guaranteed as to principal or interest, by the U.S. or any of its governmental agencies (government securities), by any credit ratings agency, is not a factor in determining the net capital treatment for such securities. FINRA staff has confirmed with SEC staff that this ratings action by Standard & Poor's does not alter the net capital treatment of these government securities under Exchange Act Rule 15c3-1(c)(2)(vi)(A).

Click here to read Regulatory Notice 11-38.

Trading Pause Pilot Rule Expanded to all NMS Stocks

Effective August 8, the trading pause pilot rule—which was applicable only to securities included in the S&P 500 Index, the Russell 1000 Index and a list of selected exchange-traded products—was expanded to include all National Market System (NMS) stocks. The expanded trading pause pilot rule requires a threshold move of 30% (or more) to trigger a trading pause for NMS securities where they are priced at $1.00 or more, and a threshold move of 50% (or more) where such securities are priced less than $1.00. According to the Financial Industry Regulatory Authority, Inc., the expansion of the trading pause pilot rule applies the trading pause protections against excessive volatility to a wider group of securities, and permits further review and assessment of the operation of trading pauses, including whether alternative measures are appropriate.

Click here to read Regulatory Notice 11-37.

LITIGATION

Delaware Court Upholds Transfer of Voting Interests to an Existing LLC Member

The Delaware Court of Chancery has upheld the assignment of a Delaware limited liability company membership interest, including the voting rights associated with that interest, to an existing member of the LLC. Omniglow LLC had three members: (i) plaintiff Achaian, Inc., which owned 20% of Omniglow; (ii) defendant Leemon Family LLC, which owned 50% of Omniglow; and (iii) Randye M. Holland, who had owned a 30% membership interest in Omniglow. In January 2010, Holland purported to transfer and assign its entire 30% interest to Achaian. Achaian then filed suit seeking an order of dissolution of Omniglow, asserting that it and Leemon were deadlocked with respect to the management of the company. Leemon opposed the motion, arguing, among other things, that Holland could not assign his voting rights in the LLC without Leemon's consent.

The court noted that pursuant to the Delaware LLC Act, the transfer of a member's interest transfers only the economic interest, but no voting rights, unless the operating agreement of the LLC provides otherwise. However, reading Omniglow's operating agreement as a whole, the court determined that it allowed for a member to transfer its entire membership interest, including voting rights, to another existing member without obtaining the unanimous consent of all members.

The court's decision was based primarily on its interpretation of two clauses in Omniglow's operating agreement. First, the operating agreement provided that a member was permitted to transfer all or any portion of its "Interest," a term defined as the "entire ownership interest" of the member. The court held that it was preferable to construe the term "entire ownership interest" as including the voting rights associated with an interest.

Second, the court rejected Leemon's argument that the operating agreement's provision requiring the approval of each existing member before a new member could be admitted required unanimous consent before a member could increase its share of voting interests. In so holding, the court noted that the plain language of the provision did not support its application to existing members and pointed out that its interpretation did not conflict with the traditional purpose behind such a provision, ensuring that "one gets to choose one's own business partners."

Achaian, Inc. v. Leemon Family LLC, No. 6261-CS (Del. Ch. Aug. 9, 2011).

Delaware Chancery Court Orders Hedge Fund to Return $40 Million Seed Investment

An investment fund (the Lerner Fund) controlled by Randy Lerner, the owner of the Cleveland Browns, recently obtained a court order for the return of the remainder of its $40 million seed investment in a hedge fund (the Paige Fund) managed by Paige Capital Management LLC. After the expiration of the three year lock-up period, the Lerner Fund sought to redeem its full investment. The Paige Fund and its managers (the Paiges) refused to allow the full redemption and instead attempted to apply a "gate" provision in the Paige Fund's partnership agreement that limited redemptions if they would cause more than 20% of the fund's assets to be withdrawn. The Lerner Fund was the only investor in the fund other than a principal of the Paiges, and its redemption request, if honored, would have resulted in the withdrawal of 99.9% of the Paige Fund's assets.

The Delaware Chancery Court ruled that the Paiges' attempted use of the gate provision was improper on two independent grounds. First, the court ruled that the Lerner Fund's withdrawal rights were not governed by the Paige Fund's partnership agreement, but instead were governed by a separate seeder agreement between the parties that permitted withdrawal after the three-year lock-up period, without any gate. In doing so, the court rejected the Paiges' argument that the gate provision in the partnership agreement controlled because the seeder agreement contained a provision specifically stating that it was not amending the partnership agreement "in any manner." The court determined that the seeder agreement was not inconsistent with, or an amendment of, the partnership agreement, but rather was an agreement made pursuant to the partnership agreement's grant of authority to the Paige Fund's general partner to modify its terms relating to withdrawals for "certain large or strategic investors."

Second, the court ruled that even if the partnership agreement's gate provision governed, it was a breach of fiduciary duty for the Paiges to impose the gate because it was utilized solely to protect the Paiges' interests. The court ruled that because the Paige Fund had no outside investors to protect, and had not even introduced any evidence that its principal's own $40 thousand dollar investment would be harmed by the withdrawal of the Lerner Fund's investment, the imposition of the gate was nothing more than an improper attempt to continue obtaining management fees. The court also pointed out that the language in the partnership agreement giving the fund the "sole discretion" to determine whether to impose the gate did not alter the analysis or relieve the fund and its principals from exercising that discretion in a manner consistent with its fiduciary duties.

Paige Capital Management, LLC v. Lerner Master Fund, LLC, C.A. No. 5502-CS (Del. Ch. Aug. 8, 2011).

BANKING

FHFA, Treasury, HUD Seek Input on Disposition of Real Estate Owned Properties

On August 10, the Federal Housing Finance Agency (FHFA), in consultation with the U.S. Department of the Treasury and Department of Housing and Urban Development (HUD), has announced a Request For Information (RFI), seeking input on new options for selling single-family real estate owned (REO) properties held by Fannie Mae and Freddie Mac (the Enterprises), and the Federal Housing Administration (FHA). According to the release, "The RFI's objective is to help address current and future REO inventory. It will explore alternatives for maximizing value to taxpayers and increasing private investment in the housing market, including approaches that support rental and affordable housing needs." A specific goal is to solicit ideas from market participants that would maximize the economic value that may arise from pooling the single-family REO properties in specified geographic areas.

The RFI calls for approaches that:

- reduce the REO portfolios of the Enterprises and FHA in a cost-effective manner;

- reduce average loan loss severities to the Enterprises and FHA relative to individual distressed property sales;
- address property repair and rehabilitation needs;
- respond to economic and real estate conditions in specific geographies;
- assist in neighborhood and home price stabilization efforts; and
- suggest analytic approaches to determine the appropriate disposition strategy for individual properties, whether sale, rental, or, in certain instances, demolition.

FHFA, Treasury and HUD anticipate respondents may best address these objectives through REO to rental structures, but respondents are encouraged to propose strategies they believe best accomplish the RFI's objectives. Proposed strategies, transactions, and venture structures may also include:

- programs for previous homeowners to rent properties or for current renters to become owners ("lease-to-own");
- strategies through which REO assets could be used to support markets with a strong demand for rental units and a substantial volume of REO;
- a mechanism for private owners of REO inventory to eventually participate in the transactions; and
- support for affordable housing.

Click here to read the RFI.

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