March 10, 2003

Third Circuit Decision Limits
Exemptions from Section 16 Liability

A recent appellate court decision limits two important exemptions from short-swing-profit liability under Section 16(b) of the Securities Exchange Act — the exemption for transactions between an issuer and its officers and directors (Rule 16b-3) and the exemption for reclassifications (Rule 16b-7). In *Levy* v. *Sterling*, 314 F.3d 106 (2002), the Third Circuit reversed the district court's dismissal of a Section 16(b) lawsuit involving the pre-IPO stock reclassification of Fairchild Semiconductor International, in which all shares of Fairchild's preferred stock were automatically converted into common stock. The plaintiff alleged that the reclassification of defendants' preferred stock into common constituted a "purchase" of the common stock by the defendants, which could be matched against their sales of common stock within six months to trigger short-swing liability under Section 16(b). In rejecting arguments that Rules 16b-3(d) and 16b-7 exempted the transaction, the Third Circuit narrowed the applicability of these rules.

Rule 16b-3(d) is frequently relied upon to exempt grants, awards and other issuances to officers and directors in shareholder- or board-approved transactions. Departing from what appeared to be clear guidance from the SEC, the Third Circuit introduced a requirement that the transaction must have "a compensatory nexus" — "some connection to a compensation-related transaction" — to be exempt under Rule 16b-3(d).

Rule 16b-7 exempts transactions pursuant to certain mergers, reclassifications and consolidations. In previous no-action letters, the SEC staff had indicated that Rule 16b-7 is available to exempt reclassifications where, among other things, the reclassification does not change the shareholders' overall proportionate investments in the company. The Third Circuit held that Rule 16b-7 would not exempt the Fairchild transaction for two reasons: (1) the reclassification of preferred stock into common allegedly increased the defendants' proportionate interest in Fairchild's *common stock* (even though it may not have changed their proportionate investments in the company); and (2) the preferred stock reclassified was non-convertible preferred stock, which carries risks and opportunities different from common stock.

The defendants in *Levy* v. *Sterling* have petitioned the Third Circuit to rehear the case, and the SEC has filed an *amicus curiae* brief supporting the petition for rehearing and the defendants' position that the transaction was exempt under both Rules 16b-3 and 16b-7. Notwithstanding the SEC's position, unless the Third Circuit's decision is vacated, officers and directors seeking to rely on Rule 16b-3(d) to exempt grant, award or other transactions with an issuer should take care to ensure that the record reflects that the transaction is integrally related to compensation. Similarly, issuers and shareholders considering reclassification and similar transactions must be extremely cautious in relying on prior SEC no-action letters as the basis for a Rule 16b-7 exemption.

Barry A. Bryer
Paul Vizcarrondo, Jr.
David M. Silk
Michael A. Charish