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Second Circuit rejects novel theory of recovery under Section 16(b) "short-swing" trading rule

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In a case that had threatened to upend the underlying legal framework governing how publicly held corporations manage the award and exercise of stock options granted to their executives and other insiders, a highly-anticipated decision from the Second Circuit yesterday stepped back from an earlier indication that it may have been considering a novel theory of liability and instead reaffirmed the widespread understanding that transactions with insiders that fall within statutory exemptions to the "short-swing" trading rule will not trigger the strict liability to disgorge profits from such transactions.

In *Olagues v. Icahn et al.* (2nd Cir., No. 16-1259), the court rejected a claim that billionaire investor Carl Icahn had violated the prohibition on "short-swing profits" based on certain transactions involving shares of Herbalife, Nuance Communications and Hologic. In general, securities laws prohibit insiders from engaging in "short-swing" transactions, such as purchases or exercises and sales of options within six months of each other, based on the theoretical premise that insiders' knowledge of the company will inevitably influence the timing of their transactions. The exercise of an option followed shortly by the sale of the stock can trigger liability even if the option was granted many years before the exercise. If an insider does execute such a trade, Section 16(b) of the Securities Exchange Act of 1934 provides that the issuer (or more likely a plaintiff claiming to act for the issuer) can sue the executive for disgorgement of any profits. The statute was intended to limit the opportunity for insider trading, but is a strict liability rule that applies regardless of insider knowledge or intent. The SEC Rules provide several important exemptions, including for transactions that were approved by the Board (or a committee of independent directors), were approved or ratified by shareholders, whose terms were fixed, and where the officer held a "derivative" security for more than six months.

In the *Icahn* case, the plaintiff advanced a novel theory by which he claimed that certain put options "did not reflect the true economic value of those transactions," because the issuers also purportedly received "additional undeclared consideration" and, therefore asked that the call options be recharacterized as "premium" and disgorged as short-swing profits. During the oral argument, some judges on the Second Circuit panel seemed to be inclined to consider some of plaintiff's arguments, but the panel's decision ultimately affirmed the ruling of the district court, which had concluded that "the analytical steps required in [p]laintiff's theory to establish liability…

is a bridge too far to establish that [d]efendants must disgorge more in profits than they already have—maybe five or six bridges too far." Order on Motion to Dismiss at 10-11.

The Second Circuit's ruling returned to the purpose of Section 16(b), noting that "the SEC's central concern when it promulgated Rule 16b-6(d), which was to stop an insider from receiving and retaining a premium for an option 'knowing, by virtue of his inside information, that the option will not be exercised within six months' and hence that no shares will exchange hands." Decision at 14. The court held that with respect to Icahn's transactions, "no additional profit was made in the sense intended by Rule 16b-6(d) because the underlying shares did in fact change hands." *Id.*

This ruling underscores that Section 16(b)'s application can be complex and the impact on executives can be severe if a credible violation is identified. However, there are also many ways that transactions can be exempted from the short-swing regulations if structured and disclosed properly. Because navigating these exemptions can pose challenges for companies and executives who have stock options as part of their compensation program, advance planning will remain paramount for public companies wishing to ensure that their grants and exercises fall squarely within the Section 16(b) exemptions and reduce the risk of liability.

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