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Litigation

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SECOND CIRCUIT HOLDS THAT “DIRECTORS BY DEPUTIZATION” QUALIFY FOR RULE EXEMPTING CERTAIN APPROVED TRANSACTIONS FROM SHORT-SWING LIABILITY

By Renée Sekino

In a decision issued on April 10, 2008, *Roth v. Perseus*,¹ the United States Court of Appeals for the Second Circuit held that Rule 16b-3(d) applies to “directors by deputization” -- that is, shareholders who exercise the power to appoint directors to an issuer’s board. The import of the decision is that it permits institutional investors to engage in certain transactions that would otherwise have been captured by Section 16(b)’s prohibition against short- swing profits.

Section 16(b) and Rule 16b-3(d). Section 16(b) of the Securities Exchange Act of 1934, which applies to any company whose

securities are registered on a national securities exchange, imposes certain obligations and restrictions on the company’s insiders (*i.e.*, officers, directors, and greater than ten percent beneficial owners). Section 16(b) prohibits insiders from retaining any profits realized on “short-swing” trading transactions, commonly known to be a purchase and sale, or sale and purchase, that occurs within a period of less than six months.

The rationale behind Section 16(b) is that it provides a means by which to “prevent the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the

issuer.”² Section 16(b) imposes strict liability on insiders, and requires them to “disgorge any profit realized on all ‘purchases’ and ‘sales’ within the [six-month] period, without proof of actual abuse of insider information, and without proof of intent to profit on the basis of such information.”³ The statute provides a private right of action to shareholders, on the theory that short-swing transactions present a sufficient likelihood of abuse of inside information that a strict liability prophylactic approach is appropriate.

In *Blau v. Lehman*,⁴ the U.S. Supreme Court held that Section 16(b) encompasses shareholders who have the power to

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¹ No. 06-3771-cv, 2008 U.S. App. LEXIS 7631 (2d Cir. April 10, 2008).

² *Id.*

³ *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973).

⁴ 368 U.S. 403 (1962).

control who is appointed to the board, known as “directors by deputization”. Under the deputization theory, an entity may be deemed a director for Section 16(b) purposes where it has deputized a member of the issuer’s board of directors to act on its behalf.

Rule 16b-3(d) exempts from Section 16(b) liability certain transactions between issuers of securities and their officers and directors. In 2005, to eliminate any uncertainty, the SEC revised Rule 16b-3(d) to clarify that any acquisition from the issuer, other than a discretionary transaction, including without limitation an award or grant, whether or not intended for a compensatory or other particular purpose, is exempt if the other conditions of the rule are satisfied. Specifically, the Rule exempts any transaction involving an acquisition by an officer or director from the issuer company, so long as:

- (1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;
- (2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either:

the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; provided that such ratification occurs no later than the date of the next annual meeting of shareholders; or

- (3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, provided that this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

Roth v. Perseus.

Through various of its affiliates, Perseus, LLC (“Perseus”) invested in Beacon Power Corporation (“Beacon”). Perseus appointed two directors to Beacon’s board of directors who purported to represent the interests of Perseus and its affiliates. In 2005, two of Perseus’ affiliates acquired warrants and shares from Beacon, and, later that year, one of those affiliates distributed 7.5 million Beacon shares to its members. Those members, in turn, sold the shares.

Andrew E. Roth, a Beacon shareholder, initiated a derivative action in the United States District Court for the Southern District of New York against Perseus, certain of its affiliates, Beacon, and others, seeking to recover the short-swing profits the defendants realized on the sale of the Beacon shares. On July 28, 2006, the District Court dismissed Roth’s claims, holding that the “directors by deputization” of Beacon who also held more than ten percent of Beacon’s securities were exempt from Section 16(b) liability by virtue of Rule 16b-3(d)(1).⁵ Roth appealed, arguing that the Rule did not apply because it does not cover directors by deputization or officers and directors who hold more than ten percent of an issuer’s securities. Roth further argued that the SEC had

⁵ See *Roth ex. rel. Beacon Power Corp. v. Perseus, LLC*, No. 05 Civ. 10466 (RPP), 2006 U.S. Dist. LEXIS 52321 (S.D.N.Y. July 28, 2006).

exceeded its statutory authority in promulgating Rule 16b-3(d)(1), rendering it invalid.

On the issue of directors by deputization, the Court of Appeals first noted that the United States Supreme Court has held that an entity would be treated as a director under Section 16(b) if it deputized a director on the board of directors to act on its behalf. The Court of Appeals also took note that the SEC has adopted this deputization theory.⁶ Agreeing with the SEC that the rationale underlying Rule 16b-3(d) applies to directors by deputization with equal force as it does to standard directors, the Court of Appeals affirmed the District Court’s holding that the Rule exempts Beacon’s deputized directors from liability.⁷

Rule 16b-3(d), however, does not expressly exempt entities whose liability under Section 16(b) results from ownership of more than ten percent of the company’s listed securities. Deferring to the SEC’s interpretation of the Rule because it was not plainly erroneous or inconsistent with the law, the Court of Appeals held that the Rule 16b-3(d) exemption applies to ten percent holders who are also officers or directors.⁸

Finally, the Court of Appeals disagreed with Roth’s argument that the SEC only had discretion to exempt Section 16(b) transactions that do not give rise to speculative abuse, or where the possibility of speculative abuse is truly remote or theoretical. Rather, the Court of Appeals found that, in enacting Section 16(b), Congress explicitly left a gap for the SEC to fill, that the SEC’s expertise makes it best-suited to make policy choices in this area, and that the purpose behind Section 16(b) was to prevent insiders from taking advantage of information *not available to others*.

For those reasons, and because Rule 16b-3(d) is focused on issuer-insider transactions, where both parties have the benefit of insider information such that the opportunity for insiders to abuse inside information is not intolerably great, the Court of Appeals held that the Rule properly lies within the authority granted to the SEC by Section 16(b).

Practical Implications.

Roth v. Perseus provides greater clarity regarding the exemptive scope of Rule 16b-3(d), consistent with prior SEC interpretation. The Second Circuit’s decision means that

private equity funds, venture capital firms, hedge funds, and other institutional investors with seats on a company’s board can rely on the Section 16b-3(d) exemption when they exercise options or engage in other transactions that would otherwise have been captured by the prohibition against short-swing profits.

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⁶ Exchange Act Release 2633, Fed. Reg. 49997, 50000 (Dec. 13, 1988) (“a corporation, partnership, trust or other person can be deemed a director for purposes of section 16 where it has expressly or impliedly ‘deputized’ an individual to serve as its representative on a company’s board of directors”).

⁷ *Roth*, 2008 U.S. App. LEXIS 7631 at *6-8.

⁸ *Roth*, 2008 U.S. App. LEXIS 7631 at *8-9.

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