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Executive Compensation and Benefits Alert

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Nuisance Plaintiffs Pursue Novel Theories to Exact Section 16 Settlements

The so-called "short-swing profit rule" under Securities Exchange Act Section 16(b) generally prohibits officers and directors as well as 10 percent shareholders of a U.S. public company from profiting from any purchase or sale (or sale and purchase) of the company's equity securities within a period of less than six months. However, Rule 16b-3 permits a company's board of directors and qualifying board committees to take actions that exempt from the short-swing profit rule most transactions under the company's equity-based compensation programs.

For example, many companies take steps so that the common practice often referred to as "net settlement," in which the company withholds a portion of the shares that would otherwise be issuable upon settlement of an equity award in order to satisfy the participant's tax obligations, would be treated as an exempt disposition under Rule 16(b)-3(e). Without this exemption, the disposition of those withheld shares would be viewed as a sale and "matched" with any purchases of company equity securities made by the participant in the 12-month period beginning six months before and ending six months after the withholding. If the fair market value of the company equity securities on the date of the withholding exceeded the participant's purchase price in any such sales, the participant would be required to disgorge the excess to the company.

Recently, however, a prospective litigant (sometimes in cooperation with others) sent numerous companies demand letters claiming that such transactions are outside the scope of that exemption and should be treated as nonexempt sales subject to matching under the short-swing profit rule. The first wave of these letters sought to compel companies to make recovery of relatively modest short-swing profits supposedly realized by officers who exercised the net settlement rights granted to them by their company equity awards. The primary complainant, who has been identified as a vexatious litigant by the California state courts' Judicial Council on the basis of seemingly unrelated litigation, asserts highly technical claims (in some cases dependent on a "novel" interpretation of Internal Revenue Code Section 83(c)(3) that would change the time at which withholding would occur) that are generally inconsistent with Section 16(b), Rule 16b-3, the related Securities and Exchange Commission (SEC) proposing and adopting releases and the interpretative positions expressed by the SEC's staff. The complainants appear to be motivated by the possibility of receiving a fee to induce them to refrain from filing suit under Section 16(b) — which shareholders may do in the name of the company — or of receiving a finder's fee in cases where the company does make a recovery from its officer, however baseless the claim.

Until very recently, to our knowledge these claims had been brought regarding only relatively small amounts that would not ordinarily be viewed as justifying defending against a technical securities claim. Not surprisingly, it appears that in those circumstances, the parties have reached private settlements without any responsive filings. Companies, mindful of not appearing to circumvent the purpose of Section 16(b) by shielding their officers, have been left in the difficult position of considering whether to make recoveries from officers, notwithstanding the apparent lack of merit in the underlying theories. Quite recently, these litigants have brought claims seemingly under the same or similar arguments but relating to larger sums. These larger claims may give rise to judicial resolution, but such determinations may be slow in coming.

Until these theories are addressed by judicial or administrative authority, companies should consider taking steps to enhance their position that the Rule 16b-3 exemption will be available for insiders' dispositions of equity securities in share-withholding transactions on a going-forward basis. For example, although not alone sufficient to address all the theories raised by these litigants, companies should review their plans, award agreements, resolutions and any other relevant documents to confirm that the board or a qualifying committee has granted to company insiders the right to use share withholding at the insider's election — a provision in a plan that merely authorizes the company to *permit* share withholding is likely not sufficient for this purpose. In addition, although it should not be required in order for the Rule 16b-3 to be available, companies may be able to deprive these litigants of the purported basis for their claims by having the board or a qualifying board committee approve each specific withholding transaction immediately before it occurs, or by mandating share withholding and the time at which it must occur. In addition, until these claims are addressed, companies should consider alerting their insiders about the risks associated with purchasing shares on the market within six months of net settlements or other dispositions to the company, and vice versa.

Although it is unfortunate that the threat of meritless litigation may compel companies to change practices that already satisfy the requirements of Rule 16b-3, these steps, although burdensome and not a guarantee against future demands, may deter future claims or provide for more efficient avenues of defense in the event of litigation.