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Applicability of Section 16(b) to Insider Transactions involving Acquisitions of Unrelated Entities Owning Registered Equity Securities of an Issuer

In *At Home Corporation v. Cox Communications, et al.*,[1] the U.S. Court of Appeals for the Second Circuit (the "Court of Appeals") recently addressed the issue of whether an insider's[2] acquisition of the common stock of an issuer by acquisition of a third-party intermediary company gives rise to liability under Section 16(b) of the Securities Exchange Act of 1934[3] (the "Exchange Act") when matched with a sale of the issuer's common stock by such insider within six months of the acquisition. In dismissing At Home Corp.'s ("At Home" or the "Plaintiff") complaint, the Court of Appeals declined to rely on the "unorthodox transaction" rule of *Kern County Land Co. v. Occidental Petroleum Corp.*,[4] and instead held that Section 16(b) generally does not apply to transactions ". . . in which an insider's acquisition of an enterprise holding an issuer's stock entails appreciable risks and opportunities independent of the risks and opportunities that inhere in the stock of the issuer."[5]

Facts and History

American Telephone & Telegraph ("AT&T"), Cox Communications, Inc. ("Cox") and Comcast Online Communication ("Comcast") each owned shares of At Home's common stock. While AT&T owned approximately 35% of At Home's common stock, Cox and Comcast collectively owned more than 17% of At Home's common stock and together had the power to deprive AT&T of unilateral

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1 2006 WL 1148512 (2d Cir. Apr. 28, 2006). Defendants in this case appealed the District Court for the Southern District of New York's (the "District Court") dismissal of the plaintiff's Section 16(b) claims. *See At Home Corporation v. Cox Communications, et al.,* 340 F. Supp. 2d 404 (S.D.N.Y. 2004).

2 Officers, directors and beneficial owners of more than 10% of a class of an issuer's equity securities registered under Section 12 of the Exchange Act are "insiders" subject to the purchase-and-sale and sale-and-purchase restrictions imposed by Section 16(b).

3 15 U.S.C. §78p(b).

4 411 U.S. 582 (1973).

5 *At Home*, 2006 WL 1148512 at *6.

control of At Home's board of directors. On March 28, 2000, Cox and Comcast acquired put options to sell shares of At Home common stock to AT&T in connection with an attempt by AT&T to consolidate control of At Home. Under the letter agreement evidencing the establishment of the put options, the per share purchase price was the greater of (i) $48 or (ii) the 30-day trading average of At Home shares during the 15 days prior to, and 15 days after, the exercise of the put option. Under the terms of the put option, Cox had the right to sell up to approximately $1.4 billion worth of shares to AT&T and Comcast had the right to sell up to approximately $1.5 billion worth of shares to AT&T. Cox purchased no shares of At Home during the six months prior to or after March 28, 2000. Comcast, on the other hand, acquired three cable companies for approximately $10 billion between January 2000 and August 2000 that held warrants to purchase 8.9 million shares of At Home's common stock.

At Home brought an action under Section 16(b) to recover short-swing profits allegedly obtained by insiders of At Home. More specifically, the complaint alleged, among other claims, that Comcast sold and then purchased At Home's common stock within a six-month period in violation of Section 16(b).[6] In dismissing the Plaintiff's claim, the District Court relied on the "unorthodox transaction" rule of *Kern County*, and held that in the absence of any showing of manipulative intent, a sale of shares by one company cannot be matched for Section 16(b) purposes with a purchase of shares by another company.

Acquisitions of Unrelated Entities Holding Stock in the Issuer

The Court of Appeals began its analysis with a review of the District Court's reliance on the "borderline transaction" doctrine set forth in *Kern County* in dismissing the Plaintiff's claim.[7] Al-

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6 Under Section 16(b), "the establishment of . . . a put equivalent position . . . shall be deemed a sale of the underlying securities. . ." 17 C.F.R. §240.16b-6(a). In addition, "the disposition of underlying securities at a fixed exercise price due to the exercise of a put equivalent position shall be exempt from the operation of Section 16(b) of the Act." 17 C.F.R. §240.16b-6(b). In this case, the Court of Appeals held that because the put option was exercised at a fixed price (i.e. $48 per share), it did not need to address whether the exercise of a put option at a price calculated based on a floating mechanism would constitute a second event under Section 16(b).

7 The recapture of short-swing profits under Section 16(b) generally applies regardless of whether the insider actually used his or her inside information and regardless of his or her intent. When enacting Section 16(b) Congress implemented an objective standard of liability in order to maximize its deterrent effect by reducing the burden of proof required to establish the liability of insiders. *See Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972), *quoting Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970); *see also Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir. 1966). Despite this general rule, courts have adopted a more pragmatic approach with respect to certain transactions, often involving mergers, in which the court focuses on whether there was a potential for abuse of inside information by the insider. Generally the pragmatic approach is applied if the transaction (i) is unorthodox, (ii) is not subject to control by an insider as to timing and (iii) presents no possibility for the abuse of inside information. This pragmatic approach, often referred to as the "borderline transaction" doctrine, has been used in connection with such unorthodox transactions as "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights and warrants." *Kern County,* 411 U.S. at 593.

though acknowledging that the transaction in the case was atypical, the Court of Appeals concluded that the District Court's reliance on the "borderline transaction" doctrine was misplaced because the insider in this case was not atypical. Here Comcast did not lack access to inside information and did not sell its shares involuntarily. The Court of Appeals held that these two factors were prerequisites to a defendant's reliance on the "borderline transaction" doctrine to escape liability under Section 16(b).

After determining that *Kern County* did not resolve the case, the Court of Appeals examined the statutory language of Section 16(b) and reviewed the Congressional intent in enacting the statute. First, the Court of Appeals focused on the fact that Section 16(b) speaks of matching transactions in the equity securities of one issuer and disgorging "any profit realized . . . from any purchase and sale, or any sale and purchase, of any equity security of such issuer."[8] The Court of Appeals concluded that the statute's reference to a single "equity security" and a single "issuer" supported "an inference that a transaction in the equity securities of one company cannot be matched with a transaction in the equity securities of another."[9]

The Court of Appeals then cited the U.S. Securities and Exchange Commission's *amicus* brief in arguing that the same conclusion "is compelled by contrasting (i) the 'evils of insider trading' that concerned Congress . . . with (ii) the risks that arise when the issuer's stock is acquired indirectly by merger with another company."[10] In particular, the Court of Appeals focused on the fact that typical change-of-control transactions do not present an intolerable risk of abuse, as "[n]o one seeking an insider's edge speculating in the shares of an issuer would pursue that advantage by acquiring other companies if no more than a small fraction of the purchase price could be (notionally) attributed to the shares of the issuer."[11] The Court of Appeals determined that Comcast's $10 billion acquisition of the three cable companies entailed substantial risks unrelated to the acquisition of the At Home common stock and high transaction costs. In addition, the Court of Appeals reasoned that the maximum potential profit to Comcast from the indirect acquisition of the warrants was insignificant, as such profit was capped at a dollar value of less than five percent of the aggregate purchase price. Based on this analysis, the Court of Appeals dismissed the Plaintiff's Section 16(b) claim.

Conclusion

The Court of Appeals holding in *At Home* is significant for two primary reasons. First, this is the first case in which the federal courts have examined the question of whether an insider's acquisition of the common stock of an issuer by acquisition of a third-party intermediary company gives rise to

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8 15 U.S.C. §78p(b).

9 *At Home*, 2006 WL 1148512 at *14.

10 *Id.* at *5.

11 *Id.*

liability under Section 16(b) when matched with a sale of the issuer's common stock by such insider within six months of the acquisition. Second, in setting forth the general rule that "[S]ection 16(b) generally does not take account of transactions in which an insider's acquisition of an enterprise holding the issuer's stock entails appreciable risks and opportunities independent of the risks and opportunities that inhere in the stock of the issuer,"[12] the Court of Appeals has provided defendants in Comcast's circumstances with a new defense to Section 16(b) claims. Previously such defendants had little choice but to argue that they were not subject to the Section 16(b) profit recapture provisions based upon the application of the "unorthodox transaction" doctrine set forth in *Kern County*. Such a defense was problematic from a defendant's perspective as it required the defendant to attempt to show both an absence of control and a lack of access to inside information whether or not such factors existed. The Court of Appeals decision in *At Home* appears to evidence the increasing willingness of the federal courts to expand upon the pragmatic approach of the U.S. Supreme Court originally set forth in *Kern County* when the transaction in question does not serve "as a vehicle for the evil which Congress sought to prevent — the realization of short-swing profits based upon access to inside information."[13]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com; or Ryan Sullivan at (212) 701-3742 or rsullivan@cahill.com.

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12 *Id.* at *6.

13 *Kern County*, 411 U.S. at 594.