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Settling Section 16(b) Short Swing Claims: Who Gets a Seat at the Table?

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In an opinion this month in *Revive Investing LLC v. FBC Holdings S.A.R.L.*,[1] Magistrate Judge Gorenstein of the Southern District of New York recommended the grant of summary judgment to the defendant in a Section 16(b) "short-swing profit" action after finding that a prior settlement agreement between the defendant and different plaintiffs was valid and contained a release that precluded the claim at issue. Although Judge Gorenstein rejected the defendant's argument that only a minimal standard of review should apply to Section 16(b) settlements, he nonetheless upheld the settlement against various challenges raised by the plaintiff. Litigants in future actions involving Section 16(b) settlements will want to consult Judge Gorenstein's reasoning on the applicable standard of review and the scrutiny that courts apply to such settlements going forward.

Judge Gorenstein's opinion is also notable for an issue it does not squarely address—namely, which plaintiffs in Section 16(b) actions are actually entitled to a seat at the settlement table. Section 16(b) claims commonly involve multiple plaintiffs and plaintiffs' attorneys, and the vast majority of claims settle before a complaint is filed. In *Revive Investing LLC*, three sets of plaintiffs' lawyers initially sent demand letters to the issuer, yet only two of those lawyers were involved in settlement negotiations; the third plaintiff's attorney received no response to his letter and did not follow up for more than a year. That attorney eventually brought the suit in *Revive Investing LLC* only to learn that the claim had already been settled.

By tacitly approving the exclusion of the dormant third plaintiff from settlement talks, Judge Gorenstein's opinion has lessons for attorneys on all sides of a Section 16(b) case: Shareholders' counsel should not assume that claims will wait around for them, while defendants' counsel who have cooperative issuers might try to pick and choose the plaintiffs with whom they settle Section 16(b) claims—an outcome that could, in some circumstances, affect settlement amounts.

Section 16(b) and Short-Swing Profit Liability

Section 16(b) of the Securities Exchange Act of 1934 provides that an issuer, or a shareholder suing on an issuer's behalf, may seek disgorgement of any profits realized from the purchase and sale of any equity security in the issuer within a six-month period by insiders—i.e. directors or officers—or 10% beneficial owners of the issuer. 15 U.S.C. § 78p(b). Short-swing trading covered by Section 16(b) is a strict liability offense and, unlike the general anti-fraud provisions of the Securities Exchange Act, does not require proof of actual abuse of insider information or intent to profit.

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[1] *Revive Investing LLC v. FBC Holdings S.A.R.L.*, 20-Civ-618 (ALC) (GWG), 2021 WL 56905 (S.D.N.Y. Jan. 7, 2021). After this update was initially published, the Report & Recommendation was adopted in full by the District Court. *See Revive Investing LLC v. FBC Holdings S.A.R.L.*, 20-Civ-618 (ALC) (GWG), 2021 WL 734976, at *1 (S.D.N.Y. Feb. 25, 2021).

Unlike most federal securities laws, Section 16(b) does not grant enforcement authority to the Securities and Exchange Commission but instead allows two types of plaintiffs to pursue relief: (1) the issuer of the security that was traded; and (2) a shareholder of that issuer, but only in the event that, after the shareholder has asked the issuer to bring a Section 16(b) claim, the issuer, "fail[s] or refuse[s] to bring such suit within sixty days . . . or shall fail diligently to prosecute." 15 U.S.C. § 78p(b). The reason for allowing shareholders to pursue claims is that an issuer may not wish to go after a defendant who is, by definition, one of its insiders.

An established plaintiffs' bar has developed for bringing Section 16(b) claims, and the claims often follow a common pattern: Attorneys for plaintiff shareholders send demand letters to the issuer whose securities were allegedly subject to "short-swing" trades. If the issuer declines to seek disgorgement or fails to pursue a claim within 60 days, the shareholder may bring the claim directly against the trading party. In practice, the vast majority of Section 16(b) claims settle before a claim is filed, and it is not uncommon for multiple plaintiffs' attorneys to make demands based on the same trading, combine forces in pursuing a resolution, and then split the attorneys' fees that they receive as a percentage of the disgorgement payment.

Revive Investing LLC v. FBC Holdings S.A.R.L.

In the case of *Revive Investing LLC*, the defendant FBC Holdings S.A.R.L ("FBC") was a 10% beneficial owner of the issuer in question, Sphere 3D Corporation ("Sphere"). FBC loaned money to Sphere beginning in 2014 and, pursuant to a March 2018 amendment to this loan agreement, FBC permitted Sphere "at its option" to pay a loan extension fee and interest to FBC with shares of Sphere common stock in lieu of cash. In February 2018, before the loan amendment was finalized, FBC had reported making multiple sales of Sphere stock. Following the loan amendment, Sphere exercised its option to pay FBC in stock, and FBC reported four such acquisitions of Sphere stock. The alleged value of these transactions was approximately $1,000,000.

In April 2018, three experienced Section 16(b) attorneys representing different Sphere shareholders sent demand letters to Sphere alleging that, taken together, these transactions by FBC involving Sphere's stock violated Section 16(b). Two of these plaintiffs' attorneys—Miriam Tauber and David Lopez—decided to work together in resolving the case; the third attorney, Daniel Doherty, was counsel to Revive Investing LLC ("Revive"). Notably, Lopez and Doherty, who is not admitted to practice in New York, had worked together before on a New York case that resulted in a reported decision in another emerging area of Section 16(b) law, *Huppe v. WPCS Intern. Inc.*, 670 F.3d 214 (2d Cir. 2012). A discussion of that issue can be found in our previous alert: "Second Circuit Gives Guidance on Section 16 "Short-Swing" Profits with Possible Implications for Hedge Funds."

After receiving the demand letters, Sphere investigated the claims and declined to pursue them. Sphere notified Tauber of its decision, at which point Tauber and Lopez engaged with FBC directly. In November 2018, after three months of negotiations, FBC, Sphere, Tauber, and Lopez reached a settlement agreement in which FBC agreed to disgorge $300,000, of which 25% was paid to Tauber and Lopez as attorneys' fees. The settlement agreement included a release for FBC from "all liability and damages . . . in connection with [Sphere's] pay-down of loan debt" to FBC. There is no suggestion that Tauber or Lopez were aware of Revive's demand when they negotiated this settlement.

Meanwhile, Sphere never responded to Revive's demand letter, which Sphere had received a day after the demand letter from Lopez. A year and a half later, on October 17, 2019, Revive sent Sphere another demand letter, which also went unanswered. Revive then filed a complaint on January 23, 2020, alleging that FBC had violated Section 16(b). When FBC advised Revive that the claims had already been settled, Revive amended its complaint to challenge the settlement for failing to provide for disgorgement of 100% of FBC's alleged potential liability.

FBC moved for summary judgment against Revive, arguing that the claims in Revive's amended complaint were settled and released by Sphere in November 2018. According to FBC, the release was a contractual agreement that could be set aside only on the basis of duress, illegality, fraud, or mutual mistake. FBC argued that none of these bases were present. And while FBC argued that no additional analysis was required, it covered its bases by analyzing the settlement under the "fair, reasonable, and adequate" test that courts use for derivative claims. FBC argued that the settlement met this test, as it was "negotiated in good faith by sophisticated counsel [for shareholders]" and FBC possessed strong defenses to the claim.

Revive raised two main arguments in opposition. First, it argued that the settlement only covered FBC's acquisitions of Sphere stock that took place before April 18, 2018, which represented only a small portion of the disgorgement value; and second, it contended that the private settlement of the claims against FBC was "inadequate" and should not be enforced to prevent Revive from seeking to recover additional amounts against FBC.

Judge Gorenstein's Opinion

Judge Gorenstein did not dwell long on Revive's first objection, finding that the release language was "far broader" than Revive claimed and that it encompassed all of the Section 16(b) claims against FBC. *Revive Investing LLC*, 2021 WL 56905, at *5.

Judge Gorenstein then turned to the heart of the issue – whether the settlement was adequate. He first analyzed the appropriate standard to use in evaluating a settlement agreement that was being offered as a bar to a Section 16(b) shareholder action. Judge Gorenstein observed that Section 16(b) does not identify the applicable standard of review and noted that he had asked the parties for additional briefing on the issue. *Id.* at *6.

FBC argued that a settlement agreement should bar a plaintiff's Section 16(b) claim so long as the claim was "mature" when settled and the outcome of the claim was "genuinely disputed and uncertain." Judge Gorenstein rejected that minimal standard. *Id.* at *7. For its part, Revive proposed evaluating the settlement using the "fair, reasonable, and adequate" standard in Federal Rule of Civil Procedure 23(e)(2) for class actions settlements. Judge Gorenstein agreed with Revive and held that the November 2018 settlement had to be "fair, reasonable, and adequate" in order to preclude Revive's claim. *Id.*

Judge Gorenstein ultimately concluded that the November 2018 settlement met the "fair, reasonable, and adequate" standard. Even though the $300,000 settlement amount represented "only about 30% of FBC's potential liability," he found that FBC had strong defenses to the claim and that the settlement had been vigorously negotiated by the parties. *Id.* at *8-10. Recognizing that his "task is not to definitively decide if FBC would prevail under" its defense, he found that it was "enough to conclude that the defense was strong enough that FBC could view the Section 16(b) claim as having minimal value — in this

case no more than 30% of the profit — in light of the strength of this defense." *Id.* at *10. As a result, he concluded that Revive's claims were properly barred.

Implications for Section 16(b) Litigants

Judge Gorenstein's opinion contains several important observations for parties to Section 16(b) settlements going forward. His rejection of FBC's argument for a minimal level of scrutiny of Section 16(b) settlements means that settlements are likely to be tested going forward. Nonetheless, he was able to conclude on the facts of the case in front of him that the release was sufficiently fair to preclude Revive's claims.

Notably, Judge Gorenstein did not directly address a separate, but no less relevant, issue for similar cases going forward: Who should be included in Section 16(b) settlement discussions in the first place?

The parties' briefing, and Judge Gorenstein's opinion, acknowledge that counsel for Revive submitted a demand letter to Sphere close in time to the letters of the two other plaintiffs' counsel. Even so, Revive was not included in settlement talks. Revive noted this concern in its amended complaint, but Revive did not raise this fact as an argument against the validity of the settlement, perhaps to avoid drawing the court's attention to its delay in pursuing the claim—and to its obvious self-interest in obtaining a portion of any settlement amount. FBC, for its part, did not try to hide the fact that Revive was absent from the settlement negotiations. Instead, it portrayed Revive's challenge to the settlement as sour grapes: "[Revive's] complaint is not that the Settlement was unfair, but that [Revive's] counsel—who claims to have submitted a demand letter back in April 2018—did not get a piece of the action." Judge Gorenstein only briefly acknowledged Revive's non-involvement in settlement negotiations and did not address it in his analysis of the settlement's fairness. *Id.* at*2.

By upholding the settlement of the claims against FBC as "fair, reasonable, and adequate," Judge Gorenstein's opinion can be read as an implicit approval of Revive's exclusion from settlement talks or, alternatively, disapproval of Revive's failure to seek a seat at the table by sitting on its rights. Although Judge Gorenstein acknowledged that courts must analyze settlement negotiations to ensure they are arms' length and not collusive, defendants in future Section 16(b) cases might interpret his opinion as allowing them to pick and choose the plaintiffs with whom they settle such claims.

The implications of a defendant choosing a preferred adversary could be significant. For instance, in short-swing trading cases involving multiple potential plaintiffs, defendants could be incentivized to identify and settle with only those plaintiffs' attorneys offering the lowest settlement amounts. Meanwhile, plaintiffs' attorneys, who ordinarily seek the highest settlement amount—and therefore the greatest amount of attorneys' fees—could be incentivized to offer lower settlement amounts and settle more quickly if they know that there are other demands, lest they end up with no attorneys' fees at all. This could trigger a race to the bottom, so long as the negotiations appeared sufficiently robust to head off scrutiny and the resulting settlement amounts were not suspiciously low. This outcome would, of course, run counter to the enforcement principle and goal of Section 16(b), which is to harness individuals' private profit motive in order to encourage Section 16(b) monitoring and maximize disgorgement payments to issuers.

It is significant to note that there is no suggestion in the briefing in *Revive Investing LLC* that the two plaintiffs' attorneys who settled the action knew of the third demand letter from Revive, and they have excellent reputations in the Section 16(b) bar, so the concern over plaintiffs' attorneys aiding defendants in a race to the bottom may not have been a live issue in that case. Likewise, there is no explanation in the case for why Sphere never responded to Revive's demand letters and why Revive's counsel waited more than a year to follow up on the original demand. Nonetheless, in future cases assessing Section 16(b) settlements, courts may seek to ascertain whether the plaintiffs' counsel who settled a claim were aware of the existence of other demand letters. Until then, defendants may view the receipt of multiple demand letters as an advantage to be exploited—particularly if one of the plaintiffs does not act quickly to enforce its demand. As for shareholders, they would be wise to follow up immediately upon the expiration of the 60-day period if they want to have a seat at the table.

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