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NINTH CIRCUIT REJECTS ATTEMPT TO EXPAND SCOPE OF SHORT-SWING PROFIT INSIDER LIABILITY CLAIMS UNDER SECTION 16(b)

In *Dreiling v. America Online, Inc.,* 2009 WL 2516325 (9th Cir. May 5, 2009), the United States Court of Appeals for the Ninth Circuit held that Section 16(b) of the Securities Exchange Act of 1934 — which, broadly speaking is intended to "prevent corporate insiders from exploiting their access to information not generally available to others" by requiring disgorgement of short-swing profits from trading in securities — did not "provide a private litigant with another means of litigating securities fraud" that are prohibited under Section 10(b) and Rule 10b-5. The Court held further that a company and an individual acting on behalf of a different company who participated in "negotiations that result[ed] in the formation of a business agreement between two companies" was insufficient to create the sort of agreement necessary to establish that they were a group of "insiders" for the purpose of Section 16(b). The Ninth Circuit, therefore, rejected plaintiff's novel attempt to expand the reach and scope of liability under Section 16(b).

The action stemmed from a 1998 agreement between InfoSpace and America Online ("AOL") to create the "AOL Whitepages." The agreement was intended to exploit InfoSpace's expertise in creating online telephone directories and AOL's vast membership directory. InfoSpace was represented by, among others, its CEO, Naveen Jain ("Jain"), in its negotiations with AOL. Under the terms of the agreement, InfoSpace was to compensate AOL by: (1) granting AOL conditional warrants to purchase up to 5% of InfoSpace stock, (2) making quarterly cash payments to AOL, and (3) sharing advertising revenue generated by the AOL Whitepages. AOL would only receive this compensation if the Whitepages got a minimum number of searches. Short of that, the warrants would not vest, and AOL would forfeit quarterly cash payments. The agreement, as ultimately structured, provided that AOL would pay a $2 million penalty if it did not generate a minimum number of searches over the life of the agreement.

In late 1999, the agreement was modified. AOL agreed in principle to suspend InfoSpace's revenue sharing obligations under the agreement. Jain sought to formalize this agreement in advance of the second quarter of 2000. Jain had previously learned that InfoSpace would not meet analyst expectations for that quarter and sought to improve InfoSpace's balance sheet.

In 1999 and 2000, Jain, a large shareholder in InfoSpace, sold a significant number of shares of InfoSpace stock. Over the course of 2000, AOL also sold a significant percentage of its holdings of InfoSpace

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stock. InfoSpace stock subsequently crashed.

On these facts, Dreiling, a shareholder of InfoSpace's stock, alleged that AOL and Jain acted in concert to "(1) secretly influence the corporate affairs of InfoSpace by creating artificial revenues and earnings"; (2) "hold their shares during the creation of such artificial revenues and earnings"; and (3) "then sell their InfoSpace shares to unsuspecting investors at artificially-inflated prices."

The Court addressed, and rejected, each claim in turn. The Court concluded that "16(b) does not provide any remedy" for Dreiling's first cause of action for secretly influencing InfoSpace's corporate affairs. "At most," the Court held, Dreiling had alleged that AOL and Jain had "worked together to fraudulently inflate InfoSpace's revenues and earnings," when AOL agreed to suspend InfoSpace's revenue sharing obligations. That, the Court held, was "not within Section 16(b)'s ambit, because concerted efforts to engage in accounting fraud do not form a beneficial ownership group." Moreover, the Court noted that any Section 10(b) fraud action on the accounting issues would be barred by the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) [*see* Blog article here].

The Court held that Dreiling's second and third claims that AOL was an "insider" and, under Section 16(b), was required to disgorge any short-swing profits -- defined as the profits from any purchase and subsequent sale that took place within six months -- failed for the simple reason that AOL was not an insider.

Section 16(b) recognizes only three classes of insiders: directors, officers and "beneficial owners of more than 10%" of any class of the company's stock. As AOL was neither an officer nor a director, and on its own did not own more than 10% of InfoSpace's stock. Dreiling alleged that AOL and Jain had entered into an agreement to act as a group, and that their share ownership should be combined for purposes of calulcating the 10% shareholder test under Section 13(d) of the Exchange Act, which applies when a stockholder"agree[s] to act together" with at least one other person "for the purpose of acquiring, holding, voting or disposing of a firm's securities."

The Court disagreed, finding that Dreiling had manifestly failed to show that AOL and Jain had agreed to "act together." The Court held that the purpose of the agreement between AOL and InfoSpace was to "jointly operate the AOL Whitepages" not for AOL to acquire InfoSpace stock, noting that "[i]f AOL's main purpose was to acquire shares in InfoSpace prior to its IPO, AOL could have done so through a myriad of less complicated transactions." Moreover, the Court reasoned, *even if* AOL had entered into an "agreement" with InfoSpace to acquire 10% or more of InfoSpace's stock, the "agreement," such as it was, was between AOL and *InfoSpace*, not AOL and *Jain*. There was "no authority" for the proposition that "an individual such as Jain becomes a member of a Section 13(d) group by participating in the negotiations that result in the formation of a business agreement between two companies, absent further evidence of concerted activity." Allowing Dreiling to extend Section 13(d) to this sort of behavior would "eviscerate[] the Supreme

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Court's narrow interpretation of Section 16(b)'s reach." Finally, Dreiling had failed to produce any "evidence whatsoever of coordination between Jain and AOL regarding the stock transactions each party executed." The amendment to the agreement that suspected InfoSpace's revenue sharing obligations, "may well have been an attempt by InfoSpace and AOL to inflate InfoSpace's balance sheet," but that was "not the kind of stock-related agreement Section 13(d) contemplates."

On appeal, the Ninth Circuit affirmed the district court, and granted AOL's motion for summary judgment. The fact that there was "no probative evidence suggesting there was ever an agreement between AOL and Jain, in his personal capacity, to act together to acquire, hold, vote or dispose of InfoSpace's stock" was "fatal to Dreiling's theory of Section 16(b) liability, because it meant that AOL cannot be an 'insider' subject to disgorgement of profits derived from its InfoSpace stock trades." The Ninth Circuit strongly disapproved of Dreiling's attempt to "shoehorn facts that at worst may show aiding and abetting accounting fraud -- a theory for which Dreiling would have no recovery -- into an ill-fitting theory he hopes to broaden."

Dreiling then stands for two important principles with potentially broader application. *First*, the "blunt and unforgiving nature" of Section 16(b) means that plaintiffs alleging insider trading liability must establish true insider liability. The Court's conclusion that negotiations between an individual (Jain) – operating on behalf of his company (InfoSpace) -- and another company (AOL) did not establish an "agreement" to beneficially own 10% or more of InfoSpace's stock, suggests that plaintiffs wishing to prove insider liability must do more than simply plead a relationship between parties; they must show a true agreement to "act together." *Second*, the Court concluded that Section 16(b) applies to insider trading claims, and refused to extend its reach beyond that "narrow" confine.It refused to entertain what it effectively called a Section 10(b) claim shoehorned into a Section 16(b) action, retaining the narrow reach of claims under Section 16(b).

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