IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

MARK LEVY, Plaintiff, v. STERLING HOLDING COMPANY, LLC, NATIONAL SEMICONDUCTOR CORPORATION and FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC, Defendants.	)	C.A. No. 00-994

MEMORANDUM AND ORDER

I. INTRODUCTION

On November 28, 2000, the plaintiff Mark Levy filed this shareholder's derivative suit on behalf of the defendant Fairchild Semiconductor after making an appropriate demand to the board. The complaint alleges that defendants National Semiconductor ("National") and Sterling Holding Company ("Sterling"), who sit on the Fairchild Board of Directors, purchased Fairchild stocks and then sold those stocks at a profit within six months after purchase. Levy alleges that National and Sterling's conduct violated the prohibition on short swing profits due to insider trading expressed in section 16(b) of the Securities and Exchange Act of 1934. *See* 15 U.S.C. § 78p(b).

Presently before the court are National and Sterling's motions to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim. In both motions the defendants contend that neither defendant violated section 16(b) because the Fairchild stocks that Levy alleges were purchased were acquired during a recapitalization of Fairchild prior to its Initial Public Offering ("IPO").

Under the terms of the recapitalization, the preferred shares National and Sterling previously held were reclassified as common stock. National and Sterling contend that when shares are acquired as the result of a reclassification, the transaction cannot be considered a purchase for section 16(b) purposes because it is exempt under SEC Rule 16b-7. The court agrees with defendants and will, therefore, grant their motion to dismiss.[1] The court will explain the rationale for its decision below.

II. FACTS

National and Sterling are both incorporated in the State of Delaware. On March 11, 1997, Fairchild was spun off from National pursuant to an Agreement and Plan of Recapitalization ("Agreement"). Two provisions of the Agreement are critical. First, the Agreement permitted National and Sterling to appoint directors to Fairchild's board of directors. Fairchild's board has seven directors. Of this seven, National was permitted to select one director, Sterling was permitted to select two directors, and Sterling was permitted to designate two further independent directors.

Both National and Sterling exercised this option. Sterling appointed William N. Stout, Richard M. Cashin, and Paul Shorr. National selected Brian Halla, who served as the director of Fairchild during the events in question.[2]

The second relevant provision of the 1997 Agreement permitted National and Sterling to retain or purchase stock in Fairchild. National retained 4,380,000 shares of class A common stock, 5,243,621

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[1] The court's decision makes it unnecessary to consider defendant's additional defenses under the Securities and Exchange Act.

[2] Halla apparently ceased his service as a director in January 2000.

shares of class B common stock, and 11,667 shares of 12% series A cumulative compounding preferred stock. Sterling purchased 3,553,000 shares of class A common stock, 7,099,000 shares of class B common stock, and 53,113 shares of the preferred stock. Thus, according to a prospectus filed by Fairchild on August 4, 1999, National was the beneficial owner of 14.8% of class A common stock and 14.9% of class B common stock. The prospectus also disclosed that by 1999, Sterling was the beneficial owner of 48.0% of the class A common stock and 85.1% of the class B common stock.[3] Thus, both National and Sterling had stock ownership in Fairchild exceeding ten percent.

Earlier in 1999, Fairchild decided to undergo a recapitalization in anticipation of its IPO. The recapitalization contemplated that preferred shares would be converted to common stock. Fairchild's certificate of incorporation, however, did not provide for the conversion of preferred stock into common stock. On July 1, 1999, a majority of Fairchild's common and preferred shareholders voted to convert all shares of preferred stock into class A common stock "automatically" upon completion of the IPO. The certificate of incorporation was amended to reflect the change, and also set out a formula for the conversion of the shares.[4] According to the formula, each share of preferred stock was worth 75.714571 shares of class A common stock. Thus, Sterling acquired 4,021,428 shares of common stock and National acquired 888,362 shares. The acquisition occurred on August 9, 1999, the date the IPO was completed.

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[3] By 1999, Sterling's number of shares had grown to 14,212,000 shares of class A common stock and 28,396,000 shares of class B common stock. D.I. 1 at ¶ 13.

[4] The formula required that each investor would receive $1,000 per share liquidated value for the preferred stock plus accumulated unpaid dividends. This number was then divided by $17.39 per share to arrive at a 75 to 1 ratio.

On January 19, 2000, Sterling sold 11,115,000 shares of class A common stock for a profit of $58,511,777.00. National sold 7,243,360 shares of class A common stock at a profit of $14,124,958.00 on the same date. Both sales were within six months of the time National and Sterling acquired the new shares of common stock.

III. STANDARD OF REVIEW

In ruling on a motion to dismiss, the factual allegations of the complaint must be accepted as true. *See Graves v. Lowery*, 117 F.3d 723, 726 (3d Cir. 1997); *Nami v. Fauver*, 82 F.3d 63, 65 (3d Cir. 1996). Moreover, a court must view all reasonable inferences that may be drawn from the complaint in the light most favorable to the non-moving party. *See Jenkins v. McKeithen*, 395 U.S. 411, 421 (1969); *Schrob v. Catterson*, 948 F.2d 1402, 1405 (3d Cir. 1991). A court should dismiss a complaint "only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *See Graves*, 117 F.3d at 726; *Nami*, 82 F.3d at 65 (both citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)).

IV. DISCUSSION

Section 16(b) of the Securities and Exchange Act is intended to prevent "the unfair use of information . . . by beneficial owner [s] , director [s], or officer[s] " in connection with "any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months." *See* 15 U.S.C. § 78(p)(b). Thus, by the language of the statute at least two elements must be

present: (1) beneficial owners, directors, or officers (commonly known as insiders); and (2) a purchase or sale within six months.

The parties do not dispute that both National and Sterling are insiders. Indeed, both corporations owned over ten percent of the Fairchild shares, which qualifies them as beneficial owners. *See* 15 U.S.C. § 78(p)(a) (defining beneficial owner as one owning more than "ten percentum" of the stock at issue). Moreover, even if this were not so, both National and Sterling sent representatives to Fairchild's board of directors. Since three of these directors were not independent, they can be considered agents of National and Sterling. Thus, National and Sterling were also directors of Fairchild. *See id.* (mentioning directors and officers). Due to their involvement as directors and beneficial owners, both companies are subject to the provisions of the Securities and Exchange Act. The court therefore, need only determine whether their actions violated the applicable securities laws.

A. Reclassifications are Exempt under the Securities Laws

Although the parties agree that National and Sterling were insiders, the parties vigorously dispute whether the transaction at issue involved a "purchase." As defendants point out, the Securities and Exchange Commission has exempted several transactions from the scope of the term "purchase." In particular, the SEC has exempted "mergers, reclassifications, and consolidations" via SEC Rule 16b-7. *See* 17 C.F.R. § 240.16b-7. As Levy points out in his brief, reclassifications are not explicitly discussed in Rule 16b-7. Nevertheless, in a 1981 Interpretive Release, the SEC was asked "Although not specifically mentioned, does Rule 16b-7 apply to . . . reclassifications?" *See* Interpretive Release on Rules Applicable

to Insider Reporting and Trading, Exchange Act Release No. 18114, 23 SEC Docket 856, 914 (Question 142) (Sept. 24, 1981), *available at* 1981 WL
31301. The SEC replied that the rule "can be applied to reclassifications." *See id.* In light of the SEC's own interpretation of its rules and regulations, it seems clear the provisions of Rule 16b-7 apply to reclassifications. It would seem then that reclassifications are exempt from the scope of Section 16(b).

B. The Transaction Here was a Reclassification

When presented with facts similar to those before the court, the SEC has ruled that section 16(b) was not violated. In the *Monk-Austin, Inc.,* case, SEC No-Action letter, 1992 WL 337451, Monk-Austin wrote to the SEC inquiring whether its proposed IPO would violate securities laws. Monk-Austin completed a recapitalization wherein its capital stock would be converted into a new class of common stock. *Id.* at *1. The SEC ruled that the recapitalization was exempt under Rule 16b-7. *Id.* at *8. At least one reported circuit court decision is in accord with this result. *See Roberts v. Eaton*, 212 F.2d 82, 83 (2d Cir. 1954) (rejecting argument that reclassification should be considered a purchase).

The facts here are similar to those in *Monk-Austin.* As in *Monk-Austin*, here Fairchild simply reclassified its stock from one form to another. Thus, it appears that the Fairchild transaction should also be considered a reclassification. Although Levy attempts to distinguish *Monk-Austin* by noting that in *Monk-Austin*, the shares were convertible from the inception of the corporation, the court agrees with the defendants that this fact did not appear to influence the SEC's decision.

Levy further argues that the exchange here should not be considered a reclassification because it was actually a liquidation. The court disagrees. Although the liquidated value of the stock was used to compute the conversion formula, this will not qualify the transaction as a liquidation of stock as neither National nor Sterling nor any of the other investors received any cash for their value. In *Monk-Austin*, a similar formula was employed without objection by the SEC. *See Monk-Austin*, 1992 WL 337451, at *5 (noting that shareholders were to receive $52 per share upon liquidation and that number was incorporated into the formula for conversion of stocks). The court will, therefore, reject the argument made here.

Levy also attempts to argue that the transaction here should not be considered a reclassification because National and Fairchild actually increased their ownership interests. However, in *Monk-Austin*, the court noted that there was a "conversion ratio of 128-for-1 . . . so there is no shift of proportionate interests . . . " *See id.* at *6. In the present case, there is a conversion ratio of approximately 75-to-1. This formula is similar to the one employed in *Monk-Austin*. Although Levy asserts that this formula gave National and Sterling a larger interest in the corporation, according to the formula, the interest in the corporation would remain the same because the amount of common shares issued would depend solely on the value of the preferred shares currently held. Thus, neither Sterling nor National acquired a substantially greater interest in Fairchild.

Morever, even if the corporation's interests and profits did increase, this will not be dispositive where the transaction does not change the "character of the investment or the nature of the market risk assumed." *Rothenberg v. United Brands*, 1977 WL 1014, at *6-*7 (S.D.N.Y. May 11, 1977). The critical inquiry here appears to be whether the stocks are exchanged for items with a higher intrinsic value.

Compare id. at *2 (holding that section 16(b) not violated in converting one type of stock to another type of stock although converted stock had "greater economic value") with *Colan v. Mesa Petroleum Co.*, 951 F.2d 1512, 1525 (9th Cir. 1991) (finding section 16(b) liability where stock was exchanged for debt securities, which had "higher market value."). In the present case, neither the character nor the risk changed because the Fairchild preferred stock was exchanged for substantially similar securities with a similar market risk involved. Thus, unlike *Colan*, Fairchild did not attempt to exchange stocks for investments - such as bonds - that present a different sort of market risk and, therefore, a possibly greater market value. Since the investment security and the associated risk remained constant before and after the conversion, the court finds no reason to hold that this transaction should not be treated as a reclassification.

On balance, the court finds that all relevant factors indicate that the transaction here was a reclassification of stock in anticipation of an IPO, rather than a purchase. The SEC has repeatedly interpreted its regulations as exempting reclassifications from the scope of section 16(b). Thus, the court concludes that in light of the facts presented, the transaction here does not subject either of the defendants to section 16(b) liability. As a result, the court finds the plaintiff has failed to state a claim for which relief can be granted, and will dismiss the complaint.

V. CONCLUSION

For the foregoing reasons, Levy has failed to state a claim for which relief can be granted. The court will, therefore, grant each defendants' motion to dismiss the complaint pursuant to Rule 12(b)(6).

NOW, THEREFORE, IT IS HEREBY ORDERED that:

1. The defendant Sterling's "Motion to Dismiss" (D.I. 7) is GRANTED;

2. The defendant National Semiconductor's "Motion to Dismiss" (D.I. 9) is GRANTED;

3. The Plaintiff's Complaint (D.I. 1) is DISMISSED With Prejudice;

4. The clerk shall close this case.

Dated: February 5, 2002

Gregory M. Sleet
UNITED STATES DISTRICT JUDGE