

January 31, 2008

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Eva Marie Carney
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RE: A Third District Court Has Dismissed SEC
Claims Relating To Short Sellings and PIPES

A THIRD DISTRICT COURT HAS DISMISSED SEC CLAIMS RELATING TO SHORT SELLING AND PIPES

The SEC's litigators apparently are not giving up on their Section 5 theory, but they are not convincing federal district courts of their theory. In the face of two recent district court rulings rejecting the agency's position that it is a violation of Section 5 of the Securities Act of 1933 to use shares obtained in a private investment in public equity (PIPE) transaction to cover a short position taken in the PIPE issuer, SEC litigators argued, in effect, that those courts were mistaken. (We reported on those earlier rulings, SEC v. Lyon and SEC v. Mangan, in a January 7, 2008 Client Memorandum.) The new arguments, while passionate, were not persuasive, as the district court dismissed the Section 5 claims. The case is SEC v. Berlacher, Civ. Action No. 07-3800-ER (E.D. Pa.) (Eduardo, J., Robreno C.); Mr. Berlacher manages Lancaster Investment Partners, L.P., among other investment funds.

The Berlacher court ruled on January 23, 2008, without issuing an opinion explaining the basis for the ruling. The SEC's litigators had sought to convince the court that the defendants' short sales should be deemed sales of the unregistered PIPE shares (a position with which the Lyon court disagreed). Alternatively, the litigators pressed the position that the defendants were acting as statutory underwriters, that their short sales were part of a larger distribution "transaction," and that, because no registration statement covered the short sales, the SEC had satisfied its prima facie case for a Section 5 violation.

While it granted the motion to dismiss the Section 5 claims with prejudice, the Berlacher court allowed the case to proceed to discovery with respect to the SEC's additional claim that the defendants told a particular issuer that they would not sell short its common stock but then engaged in such sales.

The SEC's complaint also included an insider trading claim. It alleged that the defendants expressly agreed, as a condition to their receipt of information about a particular PIPE offering, to keep information about the PIPE confidential, and to restrict themselves from trading in the securities of the PIPE issuer until the PIPE was publicly announced, but that they nonetheless traded in the issuer's shares before that

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announcement. Berlacher dismissed the insider trading claim without prejudice, in light of the defendants' assertion that the "confidential PIPE information" was not pled with specificity. We anticipate that the SEC promptly will amend its claim accordingly.

Based on its handling of Berlacher, the SEC is not inclined to abandon its position that short selling to hedge a PIPE transaction and covering with the shares obtained in the PIPE is an unlawful public distribution of unregistered securities. As its losses in the district courts mount, it seems all the more likely that the SEC will seek to address the issue through rulemaking. In the interim, district courts are giving SEC litigators the green light to press forward with misrepresentation and insider trading claims against short-selling PIPE participants.