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E-Filed 1/18/2012

**IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION**

SANTA CLARA VALLEY HOUSING
GROUP, INC., et al.,
Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

Case No. 5:08-cv-05097-WHA

ORDER¹ GRANTING PLAINTIFFS' MOTION
FOR RECONSIDERATION IN PART AND
MODIFYING ORDER OF SEPTEMBER 21,
2011

[re: dkt. entry 102]

On September 21, 2011, the Court issued an order addressing the parties' cross-motions for summary judgment. The parties sought adjudication as to whether certain warrants issued by Plaintiff Santa Clara Valley Housing Group, Inc. ("Santa Clara") constituted a second class of stock pursuant to 26 C.F.R. § 1.1361-1(l)(4) ("the regulation"). The Court concluded that the warrants did constitute a second class of stock under subsection (l)(4)(ii) but not under subsection (l)(4)(iii). Santa Clara seeks reconsideration of that ruling, asserting that the Court erred in applying subsection (l)(4)(ii) in this case and failed to consider whether the warrants fall within the safe harbor

¹ This disposition is not designated for publication in the official reports.

United States District Court
For the Northern District of California

1 established in subsection (I)(4)(iii)(C). For the reasons discussed below, the motion will be granted
2 in part.²

3 Santa Clara asserted the inapplicability of subsection (I)(4)(ii) in its summary judgment
4 briefing and at the hearing. It now makes the same arguments in greater detail. Repetition of
5 arguments previously considered and rejected by the Court is not permitted under the Civil Local
6 Rules. *See* Civ. L.R. 7-9(c). Moreover, Santa Clara’s renewed arguments do not alter the Court’s
7 conclusion that a warrant may be considered an “instrument, obligation, or arrangement issued by a
8 corporation” for purposes of subsection (I)(4)(ii).

9 A more difficult issue is raised by Santa Clara’s assertion that the Court failed to address the
10 safe harbor established by subsection (I)(4)(iii)(C). Both subsections (I)(4)(ii) and (I)(4)(iii) contain
11 safe harbor provisions. At the time it issued its ruling on the parties’ cross-motions, the Court read
12 the regulation as providing a distinct safe harbor for each subsection. It treated the safe harbor
13 provision codified at subsection (I)(4)(ii)(B) as creating an exception for instruments that otherwise
14 would be considered a second class of stock under subsection (I)(4)(ii), and it interpreted the safe
15 harbor provision codified at subsection (I)(4)(iii)(C) as setting forth an exception for instruments
16 that otherwise would be considered a second class of stock under subsection (I)(4)(iii). For this
17 reason, having concluded that subsection (I)(4)(iii) did not apply in this case, the Court did not
18 address the safe harbor provision established by subsection (I)(4)(iii)(C). The Court did not
19 understand Santa Clara to be arguing that the safe harbor provision in subsection (I)(4)(iii) applies to
20 instruments that constitute a second class of stock under subsection (I)(4)(ii).

21 In its motion for reconsideration, Santa Clara points to the following language in subsection
22 (I)(4)(i):

23 **(4) Other instruments, obligations, or arrangements treated as a second class of stock --**
24 **(i)** In general. Instruments, obligations, or arrangements are not treated as a second class of
25 stock for purposes of this paragraph (I) unless they are described in paragraph (I)([4])(ii) or
26 **(iii)** of this section. However, **in no event are instruments, obligations, or arrangements**
27 **described in paragraph (b)(4)** of this section (relating to deferred compensation plans),
28 **paragraphs (I)(4)(iii)(B) and (C)** of this section (relating to the exceptions and safe harbor
for options), **paragraph (I)(4)(ii)(B)** of this section (relating to the safe harbors for certain
short-term unwritten advances and proportionally-held debt), or **paragraph (I)(5)** of this

² The Court concludes that the motion is appropriate for disposition without oral argument pursuant to Civil Local Rule 7-1(b).

1 section (relating to the safe harbor for straight debt), **treated as a second class of stock for**
2 **purposes of this paragraph (I).**

3 26 C.F.R. § 1.1361-1(I)(4)(i) (emphasis added). The government urges the Court to interpret the
4 above language simply as listing the different safe harbor provisions that might apply *in the context*
5 of the subsection to which each safe harbor is appended. The government contends that a statutory
6 construction that would apply every safe harbor to every instrument, regardless of where in the
7 regulatory scheme the safe harbor appears, would not comport with the structure of the regulation.
8 There does not appear to be any case law on point. However, the language is unambiguous; it says
9 that “in no event” shall an instrument be treated as a second class of stock if the requirements for
10 any of the listed safe harbors are satisfied. This directive does not appear to conflict with any other
11 language in the statute or with the statute’s overall structure. Accordingly, the Court concludes that
12 the warrants do not constitute a second class of stock if they fall within the safe harbor provision of
13 (I)(4)(iii)(C). *See Barnhart v. Sigmon Coal Co., Inc.*, 534 U.S. 438, 450 (2002) (“The inquiry ceases
14 if the statutory language is unambiguous and the statutory scheme is coherent and consistent.)
15 (internal quotation marks and citation omitted).

16 Subsection (I)(4)(iii)(C) provides as follows:

17 (C) Safe harbor for certain options. A call option is not treated as a second class of stock if,
18 on the date the call option is issued, transferred by a person who is an eligible shareholder
19 under paragraph (b)(1) of this section to a person who is not an eligible shareholder under
20 paragraph (b)(1) of this section, or materially modified, the strike price of the call option is
21 at least 90 percent of the fair market value of the underlying stock on that date. For purposes
22 of this paragraph (I)(4)(iii)(C), a good faith determination of fair market value by the
23 corporation will be respected unless it can be shown that the value was substantially in error
24 and the determination of the value was not performed with reasonable diligence to obtain a
25 fair value. Failure of an option to meet this safe harbor will not necessarily result in the
26 option being treated as a second class of stock.

23 26 C.F.R. § 1.1361-1(I)(4)(iii)(C). As an initial matter, the government argues that the instruments
24 in question are not truly “warrants,” but rather are “synthetic equity instruments” that do not fall
25 within a safe harbor for call options.³ As discussed in the summary judgment order, the record is
26 clear that the warrants were issued solely to protect the Schott family’s equity in the company

27 ³ Subsection (I)(4)(iii) refers to call options, warrants, and similar instruments collectively as “call
28 options.” 26 C.F.R. § 1.1361-1(I)(4)(iii)(A).

1 during the period of time that the majority shares were “parked” in the Los Angeles Safety Members
2 Pension Plan (“LAPF”). However, it also is clear that the instruments in fact were warrants that
3 would permit the Schott family to purchase shares of the company sufficient to dilute LAPF’s shares
4 in the event that LAPF refused to sell back its shares at the agreed-upon time. Accordingly, the
5 Court cannot conclude as a matter of law that a safe harbor provision applicable to warrants does not
6 apply here.

7 Application of the subject safe harbor provision turns upon whether the strike price of the
8 warrants was at least ninety percent of the fair market value of the underlying stock on the date the
9 warrants issued. *See* 26 C.F.R. § 1.1361-1(l)(4)(iii)(C). “[A] good faith determination of fair
10 market value by the corporation will be respected unless it can be shown that the value was
11 substantially in error and the determination of the value was not performed with reasonable
12 diligence to obtain a fair value.” *Id.* Both sides presented substantial evidence, including expert
13 opinions, as to the fair market value of the shares at the time the warrants issued. This evidence is
14 sufficient to create triable issues of material fact as to the application of the safe harbor provision.
15 Accordingly, the Court will grant reconsideration with respect to this aspect of its ruling, and will
16 modify its ruling accordingly.

17 **ORDER**

18 Good cause therefor appearing,

19 (1) the motion for reconsideration is GRANTED IN PART as set forth above; and

20 (2) the Court’s ruling that the warrants constituted a second class of stock under subsection
21 26 C.F.R. § 1.1361-1(l)(4)(ii) is modified to reflect a determination that triable issues of material
22 fact exist as to whether the safe harbor provision of 26 C.F.R. § 1.1361-1(l)(4)(iii)(C) is satisfied.

23
24 DATED: January 18, 2012

25 
26 JEREMY FOGEL
27 United States District Judge
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