

Section 13(d): The Challenges of “Group Membership”

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When is an individual or entity that acts as a group with others for purposes of acquiring, holding, or disposing of securities of an issuer deemed part of a “group” as defined in Section 13(d) of the Securities Exchange Act (the “Exchange Act”) and considered a “person” required to separately file a Schedule 13D pursuant to Rule 13d-1 promulgated under the Exchange Act?²

This issue was addressed in *Hemispherx Biopharma, Inc. v. Johannesburg Consolidated Investments*, a recent decision by the Eleventh Circuit Court of Appeals.³ In *Hemispherx*, the Court considered whether individuals or entities that do not beneficially own any shares of the subject class of equity securities can be members of a “group” within the meaning of Section 13(d)(3) of the Exchange Act.⁴ The Eleventh Circuit held that a beneficial ownership interest is required to be a member of a group within the meaning of Section 13(d)(3), joining the Third Circuit in reaching that conclusion.⁵

As a result, the Eleventh Circuit held that persons that did not beneficially own any shares of the subject class of equity securities were not required to file a Schedule 13D.⁶ For the reasons discussed herein, counsel should be cautious, however, in relying too heavily upon *Hemispherx* or *Rosenberg* in advising their clients.

Understanding Section 13(d) of the Exchange Act

In 1968, Congress enacted Section 13(d) as part of the Williams Act, which sought to ensure that an issuer receives notice when a substantial amount of its stock is being accumulated.⁷ To effectuate this goal, Section 13(d)(1) requires “[a]ny person who, after acquiring directly or indirectly the beneficial ownership of any equity security . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class” to file a Schedule 13D with the Securities and Exchange Commission (“SEC”) within ten days of the acquisition.⁸

Schedule 13D requires the disclosure of a variety of very detailed and specific information regarding the filing person including, *inter alia*, information regarding (i) the identity and background of the filing person (including information regarding principal occupations, criminal convictions, and securities law violations); (ii) the source and amount of funds used to make any purchases; (iii) the purpose of the transaction (including plans or proposals relating to any additional purchases, extraordinary corporate transactions, sales of a material amount of assets, changes in the present board or management, material changes in present capitalization or business or corporate structure, changes in charter or bylaws, causing a class of securities to be delisted or deregistered; and (iv) interests in other securities of the issuer.⁹

Rule 13d-3 defines a beneficial owner as “any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares” “[v]oting power which includes the power to vote, or to direct the voting of, such security” and/or “[i]nvestment power which includes the power to dispose, or to direct the disposition of, such security.”¹⁰ Interestingly, while the definition of beneficial ownership focuses on the sole or shared power to vote or dispose of securities, Section 13(d)(3), which defines a “group” as a “person” for purposes of Section 13(d) and the rules promulgated thereunder, focus on collective efforts for the purpose of acquiring, holding, or disposing of securities:

When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a “person” for the purposes of this subsection.¹¹

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² 15 U.S.C. § 78m(d); 17 C.F.R. § 240.13d-1.

³ *Hemispherx Biopharma, Inc. v. Johannesburg Consol. Invs.*, 553 F.3d 1351 (11th Cir. 2008).

⁴ *Id.* at 1362.

⁵ See *Rosenberg v. XM Ventures*, 274 F.3d 137 (3d Cir. 2001).

⁶ *Hemispherx*, 553 F.3d at 1363-66.

⁷ *Id.*

⁸ 15 U.S.C. § 78m(d)(1) (emphasis added).

⁹ *Id.*

¹⁰ 17 C.F.R. § 240.13d-3(a).

¹¹ 15 U.S.C. § 78m(d)(3).

Rule 13d-5(b)(1) essentially provides that any “group” as defined in Section 13(d)(3) shall be deemed to have acquired beneficial ownership of all equity securities beneficially owned by the members of the group as of the date of formation of the group.¹²

The Hemispherx Decision

The Eleventh Circuit decision arose from an attempted hostile takeover of Hemispherx Biopharma, Inc. (“Hemispherx”) by two South African companies and certain officers in those companies (collectively “South African Defendants”), none of whom owned shares of Hemispherx, allegedly acting in concert with an individual who controlled a significant block of Hemispherx stock.

Hemispherx was a company engaged in the manufacture and clinical development of pharmaceuticals used in the treatment of viral and immune disorders. Hemispherx had granted a license for the development, manufacture, use, and sale of certain products to the South African-based company Bioclones (Proprietary) Limited (“Bioclones”). Bioclones proposed that the two companies merge in late 2002. Hemispherx subsequently claimed that its due diligence uncovered numerous misrepresentations on the part of Bioclones and the proposed merger did not occur.

None of the South African Defendants ever purchased any Hemispherx shares. Hemispherx claimed, however, that the South African Defendants were colluding with Bart Goemaere (“Goemaere”), a consultant who controlled 30 percent of Hemispherx’ shares, to drive down the price of Hemispherx’ shares and ultimately effect a hostile takeover of the company. As alleged in the complaint, the South African Defendants and Goemaere agreed to act as a “group” to acquire Hemispherx stock. Hemispherx claimed that by virtue of this agreement between the shareholder Goemaere and the South African Defendants, the defendants collectively “controlled” the voting of Goemaere’s shares and were thus “beneficial owners” of those shares under Section 13(d) of the Exchange Act. By virtue of this putative agreement, Hemispherx alleged, *inter alia*, that the South African Defendants beneficially owned Goemaere’s shares and violated Section 13(d) by not filing a Schedule 13D with the requisite disclosures. The district court dismissed with prejudice Hemispherx’ Section 13(d) claims against the South African Defendants on the grounds that Hemispherx did not adequately allege beneficial ownership.

The precise issue before the Eleventh Circuit was whether the complaint failed to state a claim against the South African Defendants under Section 13(d) because these defendants did not beneficially own any Hemispherx shares and consequently should not be deemed members of a “group” for purposes of Section 13(d).¹³ The Eleventh Circuit held that the South African Defendants were not members of a “group” for purposes of Section 13(d) because they did not beneficially own Hemispherx shares and consequently were not required themselves to file a Schedule 13D and affirmed the district court’s dismissal with prejudice of the Section 13(d) claims.¹⁴

However, the Court confirmed that Goemaere, the individual defendant who held over five percent ownership in Hemispherx, was required to file a Schedule 13D.¹⁵ Goemaere, in his Schedule 13D, would be required to disclose certain information regarding agreements and arrangements with other persons with whom Goemaere was acting in concert, including the South African Defendants.¹⁶ Goemaere’s Schedule 13D filing, however, would not contain all of the detailed specific information regarding the South African Defendants that would have been required to have been disclosed by the South African Defendants in separate Schedule 13D filings.

The Eleventh Circuit’s Analysis

The issue of whether individuals or entities that do not beneficially own any subject security can be members of a “group” for purposes of Section 13(d)(3) and required to separately file a Schedule 13D under Rule 13d-1 was one of first impression in the Eleventh Circuit.¹⁷ In analyzing this issue, the Eleventh Circuit looked first to the plain language of Section 13(d). The Eleventh Circuit determined that whether beneficial ownership of stock is required for group membership within the meaning of Section 13(d)(3) is

¹² 17 C.F.R. § 240.13d-5(b)(1).

¹³ *Hemispherx*, 553 F.3d at 1361. The district court had dismissed Goemaere from the action on procedural deficiencies and therefore he was not included in the appeal of the dismissal of the Section 13(d) claims.

¹⁴ *Id.* at 1366.

¹⁵ *Id.* at 1365.

¹⁶ *Id.*

¹⁷ *Id.* at 1361.

not clear from the text of the statute. "Section 13(d)(3) does not expressly require or rule out a beneficial ownership requirement, or even mention the term 'beneficial ownership.' Nor does the applicable SEC regulation address the question."¹⁸

The Court of Appeals looked next to the legislative purpose behind Section 13(d) and Section 13(d)(3) and found that "Section 13(d) is intended to ensure that an issuer receives notice that a significant amount of its shares is being accumulated."¹⁹ Section 13(d)(3) was designed "to prevent a group of persons from colluding to structure their interests in a company in a pool that would enable each individual member to avoid the reporting requirement and evade the purpose of the statute."²⁰

The *Hemispherx* court then relied upon a decision by the Third Circuit Court of Appeals in *Rosenberg v. XM Ventures* addressing claims alleging short-swing profits in violation of Section 16(b) of the Exchange Act, which concluded that beneficial ownership was a requirement of group membership.²¹ Relying upon the statutory text and its context, the Third Circuit concluded that the definition of "person" in Section 13(d)(3) and the regulations promulgated thereunder should be given the same meaning as "persons who are beneficial owners" in 13(d)(1).²² As the court stated, "the 'persons' that subsection (d)(3) refers to are the same 'persons' that Congress set forth in subsection (d)(1)—beneficial owners."²³

Following the reasoning of the Third Circuit in *Rosenberg*, the Eleventh Circuit in *Hemispherx* concluded: "[t]he implication is, of course, that each member of the [Section 13(d)(3)] group must have something to 'pool.'"²⁴ Based on the statute's purpose, the court determined, therefore, that each member of a Section 13(d)(3) group must individually have "voting or other interests in the securities of the issuer."²⁵ The court noted that if this were not the rule, Section 13(d)(3) could be expanded beyond reason to include the "attorneys, bankers, financial advisors, and accountants" who offer assistance to those acquiring the five percent ownership of the publicly traded company.²⁶

The Eleventh Circuit further reasoned that the purpose of Section 13(d) is met even though only beneficial owners of securities are required to file under Section 13(d). Any person required to make Section 13(d)(1) disclosures must identify "everyone, including those who are not beneficial owners, who possess[] some form of present or future interest in the securities, along with the details of the arrangements or understandings with those non-beneficial owners."²⁷ As a shareholder owning over five percent of the *Hemispherx* stock, Goemaere was required to disclose the identities of the South African Defendants and the details of any arrangements he had with them regarding the stock under Section 13(d)(1), even though the South African Defendants were not required to make a separate filing.²⁸

Analysis of the *Hemispherx* Decision

A careful reading of the *Hemispherx* decision, and the statutes and rules at issue, reveals the potential for inconsistent results from other courts in deciding this same issue. As a result, counsel should be hesitant to rely upon *Hemispherx* in advising their clients, as other jurisdictions could reach different conclusions.

¹⁸ *Id.* at 1363.

¹⁹ *Id.* at 1364.

²⁰ *Id.*

²¹ *Rosenberg*, 274 F.3d 137. Because SEC regulation defines "beneficial ownership" under Section 16(b) by reference to Section 13(d), the Eleventh Circuit found the Third Circuit's analysis in *Rosenberg* was equally applicable to the analysis in *Hemispherx*. See 17 C.F.R. § 240.16a-1(a)(1). Section 16(b) requires that insiders (*i.e.*, directors, officers, and beneficial owners of more than ten percent of an issuer's equity securities) disgorge any profits realized from the purchase and sale or sale and purchase of a company's stock if both transactions occur within a six-month period. 15 U.S.C. § 78p(b).

²² *Rosenberg*, 274 F.3d at 144.

²³ *Id.* at 145. The *Rosenberg* court bolstered this statutory interpretation by relying upon decisions that, while not directly on point, suggested that beneficial ownership was a requirement of group membership. *Id.* at 146; *see, e.g., Bath Indus. Inc. v. Blot*, 427 F.2d 97 (7th Cir. 1970); *SEC v. Savoy Indus., Inc.*, 586 F.2d 1149, 1164 (D.C. Cir. 1978). However, as discussed *infra*, courts interpreting a substantially similar provision of the Exchange Act, Section 14(d), have not required beneficial ownership to be a "group" member. *See, e.g., MAI Basic Four, Inc. v. Prime Computer, Inc.*, 871 F.2d 212 (1st Cir. 1989).

²⁴ *Hemispherx*, 553 F.3d at 1364 (quoting *Rosenberg*, 274 F.3d at 146) (internal quotation marks omitted).

²⁵ *Id.* (internal quotation marks omitted).

²⁶ *Id.* at 1365.

²⁷ *Id.* at 1364-65.

²⁸ As discussed above, this is arguably not sufficient. The issuer and the market are deprived of information regarding whether the South African Defendants have criminal or securities law violations and, more importantly, their plans and proposals for the issuer, which may not be the same as Goemaere and which Goemaere is not required to disclose if they are not shared.

In *Hemispherx*, the Eleventh Circuit concluded that the text of Section 13(d) and corresponding rules did not provide clear guidance on the question of whether beneficial ownership was a necessary prerequisite for Section 13(d)(3) group membership, stating:

The text of sections 13(d)(1) and 13(d)(3) leaves open the question of whether beneficial ownership of stock is required for group membership within the meaning of paragraph (d) (3). Section 13(d)(3) does not expressly require or rule out a beneficial ownership requirement, or even mention the term "beneficial owner." Nor does the applicable SEC regulation address the question. Rule 13d-5 instructs that when a section 13(d)(3) group is formed, each member of the group "shall be deemed to have acquired beneficial ownership . . . of all equity securities . . . beneficially owned by any such persons." 17 C.F.R. § 240.13d-5(b)(1). Put another way, the regulation provides that when two or more persons act as a section 13(d)(3) group, each individual member is deemed to beneficially own the securities owned by all of them. It does not rule out a non-beneficial owner becoming a member of a section 13(d)(3) group and thereby being treated as a beneficial owner of all of the securities owned by any group member. Nor does it compel that result. The regulation simply does not say one way or the other. . . . The question, then, is whether the context of section 13(d)(3) and the congressional purpose behind it show that beneficial ownership of securities is required for group membership.²⁹

The juxtaposition of Section 13(d)(1) and Section 13(d)(3) reveals, however, that Congress is explicit when it requires beneficial ownership as a condition of inclusion in the category of person. Section 13(d)(1) states as follows:

Any person who . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall . . .³⁰

Section 13(d)(3) does not contain any beneficial ownership language, providing that a "group" is formed when "two or more persons act as a partnership, limited partnership, syndicate, or other group."³¹ The implication is that when the statute does not specifically include beneficial ownership, none is required. Therefore, Section 13(d)(3), which does not include specific beneficial ownership language, does not require it.

While the Section 13(d)(3) group in the aggregate must beneficially own 5 percent of the issuer's shares, there is no requirement that each individual member be a beneficial owner. Rather, the focus should be on whether the putative members of the Section 13(d)(3) group "act[ed] as a partnership, limited partnership, syndicate, or other group for purposes of acquiring, holding, or disposing of the securities of the issuer."³²

The Eleventh Circuit's interpretation of group membership is also inconsistent with cases decided in the tender offer context, which interpreted a parallel term under Section 14(d) of the Exchange Act. Section 14(d) is a provision that was also enacted pursuant to the Williams Act, which governs disclosure required for those initiating a tender offer. Section 14(d)(1) bars an offer by "any person, directly or indirectly . . . if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than 5 per centum of such class," unless such person has filed a statement as required by the applicable rules and regulations.³³ In *MAI Basic Four, Inc. v. Prime Computer, Inc.*, the First Circuit held that Drexel Burnham ("Drexel") was a "bidder" under Rule 14d-1(b)(1).³⁴ As explained by the *MAI Basic Four* court, SEC Rules use the word "bidder" in place of "person" in the statutes.³⁵ Rule 14d-1(b) (1) provides that the term "bidder" means "any person *on whose behalf* a tender offer is made."³⁶ Drexel

²⁹ *Id.* at 1363 (citation omitted). The court's reference to "each member of the group" being required to have beneficial ownership is technically not accurate, as the text of Rule 13d-5 provides only that the "group" as a whole acquires beneficial ownership.

³⁰ 15 U.S.C. § 78m(d)(1) (emphasis added).

³¹ 15 U.S.C. § 78m(d)(3).

³² *Id.*

³³ 15 U.S.C. 78n(d)(1).

³⁴ 871 F.2d at 221.

³⁵ Rule 14d-1(b)(1) defines "bidder" as "any person who makes a tender offer or on whose behalf a tender offer is made." 17 C.F.R. § 240.14d-1(b)(1).

³⁶ 17 C.F.R. § 240.14d-1.

served as the investment banker and held equity positions in the companies seeking to take control of Prime Computer, Inc. ("Prime").³⁷

In reaching this result, the court relied upon the cross-reference to the disclosure requirements of Section 13(d), finding that the definition of "person" in Section 14(d)(2) is identical to the definition under Section 13(d)(3).³⁸ The *MAI Basic Four* court determined that the "on whose behalf" language of Rule 14d-1(b)(1) incorporates the "group" concept of Sections 13(d) and 14(d) of the Williams Act.³⁹ Similar to Section 13(d), Section 14(d)(2) incorporates the "group" concept, which defines a "person" as "[w]hen two or more persons act as a partnership, limited partnership, syndicate or other group for the purpose of acquiring, holding, or disposing of securities of an issuer."⁴⁰

After citing the same Williams Act legislative history as did the *Hemispherx* court, the First Circuit determined there was "no bright, hard-line test for bidder under the regulation."⁴¹ Under the facts of *MAI Basic Four*, the court concluded that it was "evident that Drexel had 'act[ed] as a partnership, limited partnership, . . . or other group for the purpose of acquiring, holding, or disposing of securities of an issuer.'"⁴² The court's analysis did not contemplate a beneficial ownership requirement for becoming a member of a Section 14(d)(2) group.⁴³

Instead, the court's analysis focused exclusively upon whether Drexel had acted in partnership with the acquirer for purposes of acquiring, holding, or disposing of the issuers securities, which was the analysis rejected by the *Hemispherx* court. This approach would appear to be more consistent with the intent of the statutes and focus on the activity at issue—joining together for a unified purpose—which leads to the conclusion that all individuals involved in that activity should be required to file under Section 13(d).

The Bottom Line

While the law in the Third and Eleventh Circuits currently holds that without beneficial ownership an individual is not required to file under Section 13(d), there is considerable reason for practitioners to be wary of relying upon these decisions. Other courts have reached contrary conclusions in comparable circumstances and courts in other jurisdictions could reach the same result with respect to Section 13(d). As a result, a prudent approach would be advise each individual who otherwise falls within the purview of Section 13(d)(3) to file a Schedule 13D, although the individual does not beneficially own the issuer's stock.

³⁷ Drexel also had the right to name one of the directors to an entity affiliated with one of the companies seeking to take control of Prime.

³⁸ The district court had granted Prime a preliminary injunction, holding that there had been inadequate disclosure with respect to the relationship between the companies seeking the take-over, including Drexel, particularly Drexel's relationship with these entities. The district court concluded that Drexel's relationship with these entities established that it was a "bidder" for Prime within the meaning of SEC Rule 14d-1(b)(1), 17 C.F.R. § 240.14d-1(b)(1); *MAI Basic Four*, 871 F.2d at 221.

³⁹ *MAI Basic Four*, 871 F.2d at 220.

⁴⁰ 15 U.S.C. § 78n(d)(2). "The definition of 'person' in §14(d)(2) is identical to the formulation found in §13(d)(3)." *MAI Basic Four*, 871 F.2d at 220.

⁴¹ *Id.* at 221; see also *Koppers Co. v. Am. Express Co.*, 689 F. Supp. 1371 (W.D. Pa. 1988) (holding broker/dealer to be bidder under section 14(d)(2)).

⁴² *MAI Basic Four*, 871 F.2d at 221; 15 U.S.C. § 78n(d)(2). The court characterized Drexel as "an active advisor-broker-financier-participant who owns less than a majority interest in the surviving entity . . . [with] a history of close association, equity sharing, board representation and involvement from the beginning of the present offer, and where there is the possibility of the advisor-broker being the indispensable key to the offer's success." *MAI Basic Four*, 871 F.2d at 221.

⁴³ In fact, Drexel did not stand to obtain beneficial ownership of Prime, the tender offer target.

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