

You have to be a beneficial owner

Does a person have to disclose cooperation with a significant shareholder in a US company even if it doesn't own shares?

Section 13(d) of the US Securities Exchange Act of 1934 (Exchange Act) requires any person that acquires beneficial ownership more than 5% of a class of equity securities listed on a US stock exchange to file detailed information with the US Securities and Exchange Commission (SEC). This filing, which is made on a so-called Schedule 13D, enables market participants to remain abreast of large stock accumulations and any intentions significant shareholders may have to influence control of an issuer.

One important feature of the Section 13(d) disclosure regime is the group concept. Under Section 13(d)(3) of the Exchange Act and the SEC's related rules, a person that does not have 5% beneficial ownership of a listed issuer may nonetheless become subject to the Schedule 13D filing requirement through membership in a group that has, in the aggregate, crossed the 5% threshold. A group is formed when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of an issuer's equity securities.

Investors in US public companies are accustomed to struggling with interpretive issues under Section 13(d)(3). Typically, this involves fact-intensive analyses of whether an investor's contacts with fellow shareholders show the degree of coordinated action that defines a group. A less common puzzle, however, episodically commands attention:

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can a person be a member of a Section 13(d)(3) group without actually owning stock of the issuer in question?

In late December 2008, the US Court of Appeals for the Eleventh Circuit considered this question as a matter of first impression in the circuit. In *Hemispherx Biopharma v Johannesburg Consol Invs* 2008, the court concluded that a person must have a beneficial ownership interest in the issuer's equity securities to be deemed a group member under Section 13(d)(3). The court took care to point out, however, that a non-shareholder's arrangements or understandings with an actual investor may be subject to Schedule 13D disclosure by the investor itself, if Section 13(d) applies to the investor.

Regulatory backdrop

A person subject to Section 13(d) must file its Schedule 13D with the SEC, the issuer and the exchange on which the issuer's stock is listed within 10 days of crossing the 5% beneficial ownership threshold. Schedule 13D is a detailed report that discloses, among other things: (i) the identity and background of the reporting person; (ii) the purpose of the acquisition and any plans or proposals the reporting person has with respect to the issuer (including plans or proposals to acquire additional or dispose of held securities, to change the board or management of the issuer, or to cause the issuer to engage in a large corporate transaction); and (iii) any contracts, arrangements, understandings or relationships regarding the issuer's securities to which the reporting person is a party. The reporting person must promptly amend its Schedule 13D to reflect any material changes to the initial disclosure.

Schedule 13D applies to a 5% “beneficial owner”. Rule 13d-3(a) under the Exchange Act defines that term as any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares “voting power, which includes the power to vote, or to direct the voting of, such securities,” and/or “investment power, which includes the power to dispose, or to direct the disposition of, such securities”.

It is possible to become the beneficial owner

of more than 5% of an issuer's equity securities by being part of a group that has collectively passed the 5% threshold. Section 13(d)(3) of the Exchange Act provides that “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 Section 13(d)”. Rule 13d-5(b)(1) makes explicit the link between group membership and beneficial owner status: “When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership of all equity securities of that issuer beneficially owned by any such persons.” For example, assume three investors, each of which owns 10 million shares in the issuer. If these investors form a group, each investor will be deemed to beneficially own 30 million shares.

At first glance, this notion seems clear enough. A group means two or more persons acting in concert with regard to an issuer's equity securities. If those persons together have beneficial ownership exceeding 5%, the group must file a Schedule 13D. On a closer reading, however, there is a question on which Section 13(d)(3) and Rule 13d-5(b)(1) are conspicuously silent: given that neither the statute nor the rule expressly mentions beneficial ownership as a prerequisite to group membership, does a person actually have to be a beneficial owner of the issuer's securities in order to be deemed a group member? If non-shareholder A plots with 20% shareholder B to take over a company, has A joined a group with B and thus acquired Schedule 13D reporting obligations?

The dispute in *Hemispherx*

A classic Section 13(d) litigation entails allegations by an issuer that a would-be hostile acquiror has not complied with the disclosure and/or timing requirements of Schedule 13D. *Hemispherx* is an example.

The case featured an international cast of parties. Plaintiff *Hemispherx Biopharma, Inc* (*Hemispherx*) was a Delaware corporation listed on the American Stock Exchange. The defendants were two South African corporations and several of their officers (South African Defendants), and Bart Goemaere, a Monegasque national who lived in Belgium. Goemaere owned around 30% of *Hemispherx*'s common stock. The South African Defendants owned none.

Hemispherx's suit asserted, among other things, that during 2003 and 2004 the South African Defendants worked in concert with Goemaere to force the removal of *Hemispherx*

management and take control of the company. Goemaere allegedly made strides towards this end by raising money and buying millions of Hemispherx shares. Hemispherx further claimed that a series of meetings in South Africa and international telephone communications made clear that Goemaere and the South African Defendants were acting pursuant to an express agreement to achieve a hostile acquisition of Hemispherx.

Ultimately, there was no takeover. Nor did Hemispherx allege that the South African Defendants ever purchased any Hemispherx stock. Nonetheless, Hemispherx maintained that Goemaere and the South African Defendants had agreed to act as a group to acquire, hold and vote Goemaere's Hemispherx shares; that the group jointly controlled Goemaere's shares, thus conferring beneficial ownership of those shares on the South African Defendants; and that Hemispherx was injured by the South African Defendants' failure to file a Schedule 13D disclosing their group membership and unfriendly designs on the company.

Hemispherx sued the South African Defendants and Goemaere in the federal district court in late 2004. The district court dismissed the suit against the South African Defendants for failure to state a claim under Section 13(d), on the basis that Hemispherx had inadequately pled beneficial ownership by the South African Defendants. The district court also dismissed Hemispherx's suit against Goemaere, on procedural grounds. Hemispherx appealed to the Eleventh Circuit.

The court's analysis

Beneficial ownership is a prerequisite

The court began its analysis by acknowledging the ambiguity of Section 13(d)(3) and Rule 13d-5(b)(1) on the question of whether a person must beneficially own an issuer's securities in order to be a group member:

"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 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."

In the face of this opacity, the court turned to the context of Section 13(d)(3) and its underlying legislative intent. That examination led the court to find that a person must be a beneficial owner of securities in order to be a member of a Section 13(d)(3) group.

The court stated the basic premise that

“The main value of *Hemispherx* lies in reminding investors that they must take care to disclose arrangements with non-beneficial owners”

Section 13(d) “is intended to ensure that an issuer receives notice that a significant amount of its shares is being accumulated,” citing *Rondeau v Mosinee Paper Corp.* The court then referred to Congressional legislative history for the proposition that Section 13(d)(3) in particular is designed “to prevent a group of persons from colluding to structure their interests in a company in a pool that would enable each individual to avoid the reporting requirement and evade the purpose of the statute.” In this regard, the court approvingly cited the Third Circuit’s comment that “the implication is, of course, that each member of the group must have something to ‘pool’”. The court added:

“That ‘something’ is the beneficial ownership of a security. Therefore, the goal of Section 13(d)(3) is to prevent persons who already have attained beneficial ownership of some amount of an issuer’s securities from combining to control over 5% of a class of securities, yet ducking the reporting requirement in Section 13(d)(1). That is what Section 13(d)(3) is about. That is its purpose.”

With these terse words, the Eleventh Circuit affirmed the district court’s dismissal of Hemispherx’s Section 13(d) claim against the South African Defendants.

An “absurd” result avoided

The court also observed that interpreting Section 13(d)(3) as the plaintiff urged could entail an unreasonable expansion of the group concept. Absent a requirement of beneficial ownership, the legions of professionals that might help an investor obtain a large stake in a public company – lawyers, bankers and accountants, for example – arguably would be part of a group acting for the purpose of acquiring, holding or disposing of securities. In the court’s view, “this cannot be what Congress intended. It goes far beyond what is necessary or useful to attain Congress’s goal of ‘preventing a group of persons who seek to pool their voting or other interests in the securities of an issuer from evading the provisions of the statute’ and it borders on the absurd”.

A non-shareholder’s plans may still be disclosable

The *Hemispherx* court recognised – but characterised as unfounded – the concern that its reading of Section 13(d)(3) might shield from public disclosure a non-shareholder that was meaningfully collaborating with a big investor to acquire control of a company. In the court’s view, the fact that only beneficial owners are included in a group for purposes of Section 13(d)(3) does not mean that a non-beneficial owner and its interest in the company’s securities will go undetected.

In this connection, the court pointed to Item 6 of Schedule 13D, which requires a 5% beneficial owner to disclose “information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof”. The court was confident that this requirement suffices to make public “the identity of everyone, including those who are not beneficial owners, who possesses some form of present or future interest in the securities, along with the details of the arrangements or understandings with those non-beneficial owners”.

Practical implications

Apart from establishing the Eleventh Circuit’s view that a non-beneficial owner cannot be part of a Section 13(d)(3) group, the main value of *Hemispherx* lies in reminding investors subject to Section 13(d) that they must take care under Schedule 13D to disclose arrangements with non-beneficial owners relating to the issuer’s securities. Though it is useful to bear this point in mind, the devil resides inevitably in the details. Alert Schedule 13D filers and their counsel must always analyse the specifics of a particular understanding or relationship with a non-beneficial owner in order to reach a conclusion on its disclosability.

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