Activist hedge funds continue to be cast in the role of the villains of Wall Street, and a number of corporate attorneys have been scrambling to advise public companies on how to ward off an “attack” by activist investors. In preparation for the supposedly villainous attacks, numerous companies have been formulating strategies to fend off shareholder activists.

One of the most powerful — and easiest to use — weapons that companies will employ against activist hedge funds is to allege that the activist hedge fund violated Section 13(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) by failing to disclose that the activist was acting as part of a “group” of investors with respect to its investment in the company’s stock. Rule 13d-1 of the Exchange Act requires an investor (or a group of investors) to file a Schedule 13D within ten days of acquiring beneficial ownership of more than five percent of a class of voting securities registered under the Exchange Act. (In some cases, the similar Schedule 13G may be filed.)

Because it is frequently the case that when one hedge fund takes a sizable position in a company, other hedge funds make or increase investments in the same company (the so-called “wolf-pack” effect), companies will often have a perceived basis to allege that the various hedge funds — activists or not — have engaged in sufficiently coordinated activity to be deemed a “group” under Section 13(d) of the Exchange Act. Companies seeking to repel hedge fund activists will be quick to assert that the hedge funds violated Section 13(d) on grounds that the alleged group members failed to report when their collective positions crossed the five-percent threshold.

While companies cannot sue for monetary damages under Section 13(d), they can bring an action under Section 13(d) asserting violations of the statute. Furthermore, an alleged Section 13(d) violation may have other serious consequences for activist investors, including:

- Forming a perceived basis for fraud claims, including securities fraud claims, against the investors on grounds that they concealed their group activity, sought to avoid activation of a poison pill provision or caused investors to purchase stock at artificially high or low prices resulting from the alleged failure of disclosure;
- Constituting a perceived basis upon which to grant a preliminary injunction against a proxy contest or other actions instigated by activist investors who have allegedly violated Section 13(d); and
- Providing a powerful public relations tool for entrenched management against the activist investor through the assertion that the activist investor violated the federal securities laws in connection with its investment in the company.

In addition, any whiff of “group” activity among sizeable investors may also expose activist investors and other hedge fund investors to claims for profit disgorgement for short-swing trading under Section 16(b) of the Exchange Act. Section 16(b) imposes strict liability on “corporate insiders,” including nonexempt investors who beneficially own more than ten percent of the issuer’s stock, forcing them to pay back to the company any “profits” made from purchases and sales made within a six-month period. Importantly, if two or more investors form a “group,” each group member may be liable under Section 16(b) if, in the aggregate, the group’s holdings exceed ten percent of the company’s nonexempt, registered equity securities.

And unfortunately for hedge fund investors, Section 16(b) claims may be instigated either by the company itself or by any shareholder on behalf of the company in a derivative capacity if the company fails to pursue the claims. Thus, group activity may pit the hedge fund activist against the company itself or a cadre of aggressive plaintiffs’ lawyers who need just a single shareholder as a client to pursue the profit disgorgement claims.

So with the host of serious consequences that can flow from undisclosed or unintentional group activity, as well as from bare allegations of group activity, it is obviously extremely important for activist investors to understand the essence of group activity under the federal securities laws and to disclose it when required. They must also be prepared to defend unfounded allegations of group activity.

Not surprisingly, given the absence of a “bright line test,” determining what is and what is not group activity is not always simple. One small blessing, however, is that the definition of “group” is the same under Section 13(d) and Section 16(b). Group activity in both cases is governed by Section 13(d)(3) of the Exchange Act, which provides that “[w]hen two or more persons act as a . . . group for the purpose of acquiring, holding, or disposing of securities of an issuer, such . . . group shall be deemed a ‘person.’” Rule 13d-5, in turn, goes on to define “group” as follows:

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 . . . as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons.

This statutory definition has only been slightly clarified by case law, as courts have established that the issue of group activity is a “question of fact.” In the leading case of Morales v. Quintel Entertainment, Inc., the Second Circuit parroted the statute and held that the “key inquiry” is the question of whether the members of the alleged group “agreed to act together for the purpose of acquiring, holding, voting or disposing of” their stock. There, the Second Circuit also made clear that “[t]he agreement may be formal or informal and may be proved by direct or circumstantial evidence.” Also, “the alleged group members need not be committed to ‘acquiring, holding, voting, or disposing of equity securities’ on certain specified terms, but rather they need only have combined to further a common objective regarding one of the just-recited activities.” Similarly, a “control purpose” is not necessary to trigger Section 13(d).

Thus, the Quintel holding suggests that allegations of group activity are easy to make and will almost always survive a motion to dismiss. Fortunately, however, the facts of Quintel are readily distinguishable from most activist situations. In Quintel, the alleged group members were all former co-shareholders of a closely held corporation and had deposited

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their Quintel shares in identical trusts with the same trustee. Further, the company redeemed the alleged group members’ holdings on the same date, and the alleged group members had actually at one point declared on a Schedule 13D that they were acting as a group with respect to their acquisition of Quintel stock. On these facts, the Second Circuit held that a jury could easily discredit the alleged group members’ sworn statements that they never reached any agreement with respect to Quintel stock.

A recent decision in the United States District Court for the Southern District of New York provides useful guidance on the group issue under the Quintel standard. In Litzler v. CC Investments, Judge Hellerstein held that — where the only evidence of group activity among investors in Data Race, Inc. stock was that they appointed one of the alleged group member’s lawyers to negotiate on behalf of the three investors, in response to the suggestions of Data Race’s lawyers, and that lawyer was the principal draftsman of a private placement document — there was no Section 13(d) group. Importantly, the draftsman-lawyer “took instructions from his own client and, through the other two lawyers, from their clients.” Thus, the investors each had separate counsel and were careful to maintain their independence from each other. Under these circumstances, Judge Hellerstein granted summary judgment in favor of the investors, dismissing a Section 16(b) claim against the investors.

Between the factual extremes of Quintel and Litzler are numerous other factual variants pertinent to the “group” question. Facts that various courts have found may suggest group activity under Section 13(d) include:

- Communications among the alleged group members relating to the company (although sporadic e-mails consisting of general statements of support have been held insufficient to evidence group activity);
- Copies of correspondence with the corporation being sent to other alleged group members;
- One alleged group member’s shares being held in the name of another group member;
- Statements by the alleged group members that they had the power to influence management;
- Any pattern of parallel actions by shareholders over a relatively short and essentially concurrent period of time; and
- Alleged group members providing each other with funds and/or advice.

Although almost anything can be relevant to the group issue, there are few, if any, factors that per se establish group activity short of a written agreement to act as a group. To be sure, co-sponsorship of a shareholder proposal or co-solicitation of support for such a proposal is almost certainly group activity, but such things as family relationships among investors do not necessarily establish group activity.1 And while prior business interactions with alleged group members may be relevant, the Second Circuit made it clear in Morales that a “mere business relationship” among alleged group members is insufficient to establish a Section 13(d) group. Furthermore, courts have held that discussions about a potential agreement to act as a group do not require disclosure.

But the amorphous, case-by-case approach to defining “group” activity under Section 13(d) creates a dangerous trap for activist investors and other hedge funds and, by its lack of clear determinations, provides entrenched management with a powerful weapon against such investors. Thus, hedge fund investors, particularly hedge fund activists, need always to be mindful of the “group” issue. The consequences of undisclosed group activity — or even a bare allegation of group activity — could be devastating. The allegation of undisclosed “group” activity is sure to be a weapon of choice among companies seeking to ward off “attacks” by hedge fund activists.

With care — and with the assistance of counsel — investors can, however, take important steps to avoid the “group” trap. Those in senior positions must first be educated about the importance of Rule 13(d) and should always keep in mind companies’ eagerness to discern even minor securities violations.

Obviously, explicit written agreements with other investors regarding the purchase, sale, or voting of stocks must be avoided. But investors must also be cautious in their less formal communications. Loaded terms such as “active,” “activist,” “group” or “agreement” should be avoided in written communications, and discussions of a common goal or plan for management could be cited as the “smoke” evidencing the fire of an agreement.

Above all else, funds must be vigilant about timely disclosure and meticulous about the accuracy of their public filings, ensuring strict compliance with federal securities laws. Where group status is likely to be inferred, funds may consider affirmatively disclosing in their Schedules 13D that they in fact are not a “group.” In Roth v. Jennings, a recent case in the United States District Court for the Southern District of New York, the court dismissed allegations that defendants had acted as part of a group where defendants had filed Schedules 13D expressly disclaiming group status. The court found that defendants’ SEC filings “indicate[d] that [they] never intended to act as a group” and that these filings, which had “been submitted to a government agency and made public, should not be contradicted or taken as perjurious simply because the Plaintiff, without evidence, says they are.” As in Roth, early denial of group status in a public filing can serve as a preemptive safeguard against unfounded allegations.

Finally, funds should always hire separate and independent lawyers when engaging in similar but separate investment strategies. Further, independence of separate counsel must be vigorously maintained. It is extremely important for hedge funds to avoid the trap of “sharing” lawyers as a matter of convenience in circumstances where a company seeks to reach out to multiple investors at the same time. If, as a matter of practical necessity, one lawyer must communicate with the company to convey the views of multiple investors, it must be made clear that the lawyer represents only one of the investors and that the communication is being made solely as a matter of expediency.

As companies become more creative in their defense tactics, activist hedge funds must keep aware of these developments and adjust their investment strategies accordingly. Allegations of a Section 13(d) violation can be devastating to an activist hedge fund, but, with the proper knowledge and preparedness, this threat can be avoided.

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1 See, e.g., Morales v. Quintel Entertainment, Inc., 249 F.3d 115, 124 (2d Cir. 2001).