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## Federal Securities Regulation: The Purchase Requirement for Group Filings Under Section 13(d) of the 1934 Securities Act, *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971)

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# COMMENTS

## FEDERAL SECURITIES REGULATION: THE PURCHASE REQUIREMENT FOR GROUP FILINGS UNDER SECTION 13(d) OF THE 1934 SECURITIES ACT

*GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971)

Plaintiff, issuer, alleged that defendants, members of the Milstein family, agreed to pool their preferred stock in issuer to gain control. Issuer claimed the members of the group held more than ten percent of the outstanding preferred shares; and therefore, that the group upon formation should have filed the appropriate information required by section 13(d) of the Securities Act of 1934. Injunctive relief was sought. The trial court granted stockholder's motion to dismiss for failure to state a claim.<sup>1</sup> On appeal, *held*: reversed.<sup>2</sup> The formation of a group whose members collectively hold more than ten percent of a class of a registerable security is a reportable event under section 13(d) of the 1934 Securities Act.

Congress enacted the Securities Act of 1934<sup>3</sup> to regulate security trading. The legislators chose disclosure as a principle means of accomplishing their regulatory goals.<sup>4</sup> They believed that enforced disclosure would simultaneously effect two purposes: (1) discourage fraudulent and deceptive trading practices, and (2) encourage the disclosure of information that will assist investors in making rational decisions.<sup>5</sup>

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1. *GAF Corp. v. Milstein*, 324 F. Supp. 1062 (S.D.N.Y. 1970).

2. *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

3. 15 U.S.C. § 78a (1971) (originally enacted as Act of June 6, 1934, 48 Stat. 881) [hereinafter cited as 1934 Securities Act].

4. See REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963); SEC, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 10 (1968) [hereinafter cited as WHEAT REPORT]; 1 L. LOSS, SECURITIES REGULATION 21 (2d ed. 1961). For an article discussing the use of disclosure before the Williams Act, see Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964). For an article noting the rise of suits seeking to force disclosure see Schwartz, *The Sale of Control and the 1934 Act: New Direction For Federal Corporation Law*, 15 N.Y.L.F. 674, 675 (1969).

5. WHEAT REPORT at 10.

Amendments to the original act have extended the disclosure requirements to previously uncovered areas,<sup>6</sup> and to security dealer's trading practices.<sup>7</sup> One such amendment, the Williams Act, was enacted in 1968 to require the disclosure of certain information by persons or groups who either extend tender offers to stockholders, or make sudden large-scale acquisitions of a registerable class of an issuer's securities.<sup>8</sup>

Since passage of the Williams Act, the courts have issued conflicting opinions on the question of when a group of shareholders is required to file under section 13(d). In *Bath Industries, Inc. v. Blot*,<sup>9</sup> the Seventh Circuit Court of Appeals held that a group that otherwise qualified under 13(d) must also agree to purchase additional securities before the group would be required to file.<sup>10</sup> Since the *Bath* court realized that plaintiffs would find it nearly impossible to prove the existence of such an agreement, the court formulated a rebuttable presumption to help plaintiffs. This presumption, which is actually a separate test, provided that once any member of an otherwise qualifying 13(d) group purchased any additional securities, the group will be presumed to have formed an intent to make purchases of securities and thus must file.<sup>11</sup> The district court in *Ozark Air Lines, Inc. v. Cox*<sup>12</sup> went further saying that members of an otherwise qualifying group must make a purposeful acquisition<sup>13</sup> of more than two percent<sup>14</sup> of the class of securities held by the group before a group filing would be required.

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6. See, e.g., Act of August 20, 1964, 78 Stat. 565 amending various sections of the 1934 Securities Act (extending Act's coverage to securities traded in the over-the-counter markets). For the legislative history of the 1964 amendment, see H.R. REP. No. 1418, 88th Cong., 2d Sess. (1964); 2 *U.S. Code Congressional and Administrative News*, 88th Cong., 2d Sess. 3013 (1964).

7. See, e.g., Act of August 10, 1954, tit. II, §§ 201, 202, 68 Stat. 683, amending §§ 11(d), 12(d) of the 1934 Securities Act (altering the prohibition against the extension of credit by security dealers to purchasers).

8. Act of July 29, 1968, 82 Stat. 454, amending §§ 12-14 of the 1934 Securities Act. [The acquisition provision will hereinafter be referred to as section 13(d).]

9. 427 F.2d 97 (7th Cir.), rehearing denied (July 17, 1970).

10. *Id.* at 110.

11. *Id.*

12. 326 F. Supp. 1113 (E.D. Mo. 1971).

13. The court said that defendant Cox had become a stockholder by inheritance and thus had not made a purposive acquisition; consequently a 13(d)(1) filing by him would not contribute to the maintenance of fair and honest markets. *Id.* at 1117-18. For a contrary interpretation of the Act, see *Sisak v. Wings and Wheels Express, Inc.*, CCH FED. SEC. L. REP. ¶ 92,991 (S.D.N.Y. 1970) (individual inheritor must file).

14. The court said the Williams Act was designed to protect the investing public against the impact on the market of undisclosed take-over activities by means of ac-

In the principal case the court rejected this interpretation and announced that a group must file immediately after its formation.<sup>15</sup> Group formation occurs when shareholders agree to pool their shares in an effort to affect corporate matters.<sup>16</sup> Apparently pooling need not involve the transfer of securities or the adoption of an enforceable agreement to act together.

The Williams Act was intended to fill in a gap in the securities laws, for Congress recognized the potential impact of a change in corporate control.<sup>17</sup> It was evident that certain information concerning persons or groups who might effect shifts in control would assist investors in making rational decisions. Pre-existing provisions required persons or groups who sought to acquire control either by a share-for-share exchange<sup>18</sup> or through a proxy battle<sup>19</sup> to disclose their identity and plans. Other means of acquiring control were unregulated under the securities laws. Two of these, the take-over bid and the large-scale acquisition of stock became increasingly popular with control seekers since they were less expensive than a proxy fight, were immediately decisive on the

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quisitions in excess of the exempt two percent amount. *Ozark Air Lines, Inc. v. Cox*, 326 F. Supp. 1113, 1119 (E.D. Mo. 1971). The exemption discussed provides, "any acquisition . . . which, together with all other acquisitions by the same person of securities of the same class during the preceding twelve months, does not exceed 2 percentum of that class [is exempt]" § 13(d)(6)(B). The Federal District Court for the Eastern District of New York in *Committee for New Management of Butler Aviation v. Widmark*, 335 F. Supp. 146, 155 (E.D.N.Y. 1971) also applied this exemption to group acquisitions. The *Milstein* decision, however, destroys the vitality of the *Widmark* decision, since the Second Circuit's holding in *Milstein* establishes the rule for the entire circuit. However, it is interesting to note that one member of the group in the *Butler* case had made purchases exceeding two percent prior to group formation without filing. The *Widmark* court did not permit these purchases to have any impact on the group's filing status. 335 F. Supp. at 155. *Milstein* does not affect this holding.

15. 453 F.2d 709, 713, 718.

16. *Id.* at 715-18. The court relied heavily upon Comment, *Section 13(d) and Disclosure of Corporate Equity Ownership*, 119 U. PA. L. REV. 853, 869-72 (1971). There the author argued that the Williams Act was intended to protect investors from the impact of significant shifts in corporate voting power regardless of how these shifts were accomplished.

17. A change in control brings with it the possibility of different operating results and different investment results, or perhaps the possibility of realizing on a company's liquidation value. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 151 (1966). The "gap" was noted by authorities who suggested corrections, see, e.g., Sowards & Mofsky, *Corporate Take-Over Bids: Gap in Federal Securities Regulation*, 41 ST. JOHNS L. REV. 498 (1967).

18. 15 U.S.C. § 77e(c) (1971).

19. 15 U.S.C. § 78n(a) (1971).

question of future control, and could be initiated in relative secrecy.<sup>20</sup>

The Williams Act was specifically designed to cover both of these situations and thereby provide increased investor protection.<sup>21</sup> Under the Act control seekers must expose their identity, financial sources, strength, and future plans for the corporation.<sup>22</sup> Congress expected management to respond to 13(d) disclosures by announcing their plans for the corporation. These announcements coupled with the 13(d) disclosures would provide investors with valuable information on which to base their future market decisions.<sup>23</sup>

There were, however, many witnesses at the committee hearings who testified that the disclosure requirement would primarily serve to discourage control take-overs and perpetuate management.<sup>24</sup> In response the Committee stated that the Williams Act did not "tip the scales in favor of management."<sup>25</sup> This was either a mere wishful conclusion about the Act's projected impact or an indication of how the Act should be read. The Seventh Circuit and the *Ozark* court chose the latter interpretation and construed the Act to require disclosure only after the group formulated an intent to purchase or actually purchased additional securities.<sup>26</sup>

Congress was aware that groups of persons might agree to seek con-

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20. See, e.g., Swanson, *S. 510 and the Regulation of Cash Tender Offers: Distinguishing St. George from the Dragon*, 5 HARV. J. LEGIS. 431, 448-49 (1968); Note, *The Williams Amendments: An Evaluation of the Early Returns*, 23 VAND. L. REV. 700-01 (1970). In his article Swanson noted that partial disclosure of takeovers was accomplished under section 10b and 14a, but these sections did not supply sufficient regulation. Swanson *supra*, at 457-66.

21. H.R. REP. No. 1711, 90th Cong., 2d Sess. (1968) also reported in 2 *United States Code Congressional and Administrative News*, 90th Cong., 2d Sess. 2811 (1968) [hereinafter cited *U.S. News*]. See also 119 Cong. Rec. 21954 (1968) (remarks of Senator Bennett).

22. § 13(d)(1)(A)-(E) 1934 Securities Act.

23. S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967).

24. One authority discussing *Bath* noted that 13(d) seemed to have realized these fears. 24 Sw. L.J. 542, 551 (1970). For a discussion of possible corporate defenses to takeovers see Comment, 44 TUL. L. REV. 517 (1970). An earlier proposed amendment, S. 2731, 89th Cong., 1st Sess. (1965), which was designed specifically to protect management from corporate take-over efforts failed to pass. For a discussion of how this proposal related to the Williams Act, see Comment, 71 COLUM. L. REV. 466, 469 (1971).

25. S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967); H.R. REP. No. 1711, 90th Cong., 2d Sess. 3-4 (1968), 2 *U.S. News* 2813-14. It was felt that such discouragement of tender offers that the bill would cause was "a small price to pay for adequate investor protection." *Id.*

26. See notes 9-14 *supra* and accompanying text.

trol and that such a collective force was equally able to effect control as an individual.<sup>27</sup> Under section 13(d)(1), as long as no one member held the required amount of shares,<sup>28</sup> no filing would be required and the group could proceed undetected. Congress closed this potential loophole by adding section 13(d)(3):

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 discerned a "person" for the purpose of this subsection.

The Second Circuit applied section 13(d)(3) and found that the Milsteins were a 13(d)(3) "group".<sup>29</sup> The court attempted to bolster this conclusion by noting that the group allegedly held the Milsteins' shares for the purpose of acquiring control.<sup>30</sup> Having found the Milsteins to be a 13(d)(3) group and thus a 13(d)(1) "person," the court went on to say the group "must be treated as an entity separate and distinct from its members."<sup>31</sup> The court then concluded that, through their pooling agreement, the Milstein group, "when formed, had acquired a beneficial interest in the individual holdings of its members"<sup>32</sup> and

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27. H.R. REP. No. 1711, 90th Cong. 2d Sess. 8 (1968), 2 *U.S. News* 2818. The language in this part of the report supports the *Milstein* court's conclusion that filing is required ten days after the group members agree to act together whether or not any member of the group acquired additional securities. The *Bath* court noted that this passage conflicted with other passages in the legislative history which indicated that a subsequent purchase was necessary to trigger the filing requirement. *Bath Indus., Inc. v. Blot*, 427 F.2d 97, 109 (7th Cir. 1970).

One possible explanation is that § 13(d)(3) was incorporated into the Act as an afterthought to close a potential loophole, and the legislators failed to adequately consider the impact of this addition by altering the basic act to provide consistency.

28. The original requirement that a person acquire ten percent of a class of a security registerable under § 12 of the 1934 Securities Act was subsequently lowered to require filing after a five percent acquisition, Act of December 22, 1970, 84 Stat. 149, amending § 13(d)(1) of the 1934 Securities Act. The courts have stated that this change should not be applied retroactively. *GAF Corp. v. Milstein*, 453 F.2d 709, 718 n.17; *Nicholson File Co. v. H.K. Porter Co.*, 341 F. Supp. 508, 517 (D.R.I. 1972).

29. "On the assumption that the facts alleged in the complaint are true, we cannot conclude other than that the four Milsteins constituted a 'group' . . .", 453 F.2d at 715. The court here failed to say why the facts mandated this conclusion. A similar, unsupported conclusion in *Bath* was severely criticized. See 45 N.Y.U.L. Rev. 1136, 1137-40 (1970); 24 Sw. L.J. 542, 549 (1970). For an example of a court which summarily concluded that a group did not qualify as a 13(d)(3) group see *Nicholson File Co. v. H.K. Porter Co.*, 341 F. Supp. 508, 518 (D.R.I. 1972).

30. 453 F.2d 709, 715.

31. *Id.*

32. *Id.* at 716. The court accepted the *Bath* court's statement that for purposes of

should have filed upon formation. This conclusion was supported by sections of the legislative history<sup>33</sup> and by the court's interpretation of the Act's overall purpose as being "to alert the market place to every rapid large-scale aggregation or accumulation of securities . . . which might represent a potential shift in corporate control."<sup>34</sup>

There are several problems with this decision. First, although the court concluded that no purchases subsequent to group formation were necessary to trigger the filing requirement, much of the required information under 13(d) concerns purchases and purchasers.<sup>35</sup> Use of this term "purchase" might indicate that Congress considered a subsequent purchase of significant size to be a prerequisite to filing. Also, in absence of such a purchase, three of the five items required to be filed are inapplicable.<sup>36</sup> It is inconceivable that Congress intended that a group, such as the Milsteins, need only file the remaining two items. The court did not note this problem.<sup>37</sup>

Secondly, the court's interpretation of the statutory provision is questionable. Subsection 3 of 13(d) provides that persons who act as a group to acquire, hold or sell securities are "persons" for purposes of 13(d)(1). To trigger the 13(d)(1) filing requirement a "person" must *acquire* a beneficial interest in some class of registerable securities. The court's interpretation makes these two requirements redundant, for as the group *holds* the securities it simultaneously *acquires* them.

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the Williams Act voting control is the only significant aspect of beneficial interests. *But see* C.F.R. § 240.13d-3 (1972). "In determining . . . whether a person is . . . the beneficial owner of securities . . . such person shall be deemed to be the beneficial owner of securities . . . which such person has the right to acquire through . . . options, warrants, or rights or through the conversion of presently convertible securities." *Adopted*, SEC SECURITIES EXCHANGE ACT OF 1934 RELEASE No. 8392 (August 30, 1968).

33. 453 F.2d 709, 716 citing the passage cited note 27 *supra*. However, the court stated that the legislative history was consistent. *Id.* at 717. This bare conclusion flies in the face of the entire conflict over section 13(d)(3). The court noted that Professor Loss, Milstein's co-counsel, "informed us at the argument that the view set forth in his treatise [rejecting the subsequent purchase requirement 6 L. LOSS, SECURITIES REGULATION 3664 (Supp. 1969)] was a 'mistake' and that this passage is 'diametrically opposed to the text of the statute' and the purpose and intent of the Williams Act." 453 F.2d at 717 n.15. The court did not accept Professor Loss's recantation.

34. 453 F.2d 717.

35. § 13(d)(1)(A)-(C).

36. *E.g.*, § 13(d)(1)(A) provides that, "the background and identity of all persons by whom or on whose behalf the *purchases* have been or are to be effected" must be filed (emphasis added).

37. In a footnote the court paraphrased the information required and substituted the word "person" for "purchaser." 453 F.2d at 717 n.5.

Furthermore, the group did not actually "acquire" any interest in the member's securities, rather the members of the Milstein family individually retained all rights in their own shares. Therefore, the court's interpretation results in obvious constructional problems.

Thirdly, the court's evaluation of the legislative purpose of 13(d) was inadequate in two respects. First, the court did not consider the effect of its decision on the intended neutrality of the section.<sup>38</sup> The court's holding greatly favors management, which seems contrary to the legislative intent. The second inadequacy is the court's treatment of the purpose of the Williams Act. The *Milstein* court felt that investors should have the benefit of disclosure whenever there was any type of rapid large-scale aggregation of stockholdings. However, the House Report indicates that such disclosures are required only after a rapid large-scale purchase had been made.<sup>39</sup> The Report does not indicate why this requirement does not apply to 13(d) groups.

These problems do not necessarily reflect judicial error, but rather the ambiguity of the section and its legislative history, which encourage inconsistent interpretations. Predictably, the courts are divided in the interpretation of the section. So far, the Supreme Court has refused to settle the dispute.<sup>40</sup> Unfortunately the ambiguous provisions of the section have also been incorporated into the American Law Institute's Federal Securities Code.<sup>41</sup> With an eye toward congressional action, correction of this ambiguity is recommended. The Institute should change its act to treat groups separately from individuals. In that way the Institute can tailor its provision to require filing in those instances in which the Institute feels that a group's activities should be disclosed.

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38. See notes 24-26 *supra* and accompanying text.

39. H.R. REP. NO. 1711, 90th Cong., 2d Sess. (1968).

40. The Supreme Court denied certiorari in the *Milstein* case, 406 U.S. 910 (1972).

41. ALL, FEDERAL SECURITIES CODE, Tent. Draft No. 1 (1972). Under § 276(b), "[w]hen two or more persons act in concert for the purpose of acquiring, holding, voting or disposing of securities, the group is considered a "person" for the particular purpose to the extent that the Commission so prescribes by rule."

§ 604(b) provides: "A person who as a result of acquiring the beneficial ownership of an equity security of a registrant becomes the beneficial owner of more than 5 per cent of the class shall file . . . ."

See § 604(b) Comment 6, "The Reporter . . . reserves the question whether the opening language of this section should be changed with respect to filing by groups in light of *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), as to which a petition for certiorari is pending." Since certiorari has been denied, see note 40 *supra*, the questions about changes in the opening language should now be capable of resolution.