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PRIVATE PLACEMENT INVESTORS CAUGHT IN SECTION 16(B) WEB BECAUSE COORDINATED ACTIONS CREATED POTENTIAL FOR INFERENCE OF 13(D) "GROUP"

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WHAT HAPPENED

A judge in the Southern District Court of New York recently denied a motion to dismiss filed by institutional investors in Augenbaum v. Anson Investments Master Fund LP, et al., finding that their coordinated behavior in a routine private placement gave rise to plausible claims that they formed a 10% group for Section 13(d) and therefore Section 16(b) purposes.

TAKEAWAYS

The decision follows a string of varied SDNY opinions that often deny motions to dismiss filed by defendants where the complaint alleges at least some plausible facts that could support a finding of a group. Although it may be appealed, or the factual presumptions averted at trial, the decision provides a cautionary tale for private placement investors. Some of the factors cited included:

- Investors entering into a single purchase agreement that conditioned closing on voting and lockup agreement from the controlling stockholders.
- Investors entering into a common "leak-out" agreement and concurrently converting or exercising their convertible notes and warrants.
- Investors concurrently selling their underlying shares shortly thereafter.

Because group status is determined based on facts and circumstances, a court will consider a variety of factors. No single one may be determinative or necessarily sufficient to prevent a finding a group was formed. Recognizing that SEC rules proscribe "schemes" to "evade" securities laws, some actions that investors could consider include:

- Diligencing the existence of any other beneficial ownership of the issuer's shares by investors, and any prior relationships with the issuer or its placement agent.

- For eligible passive institutional investors (13G exempt filers), utilizing Rule 13d-6(b)(2), which can prevent group status based solely on "concerted actions" in an issuer private placement, provided that:
  - All members of the group are eligible passive institutional investors.
  - The purchase is made in the ordinary course of business without the purpose or effect of changing or influencing control of the company.
  - Investors have no agreement to act together except to facilitate the purchase in the private placement.
  - The only actions among investors following the closing relate to ministerial matters related to completion of the private placement.

- Establishing the independence of each investor and its own trading strategy, including its decision to participate in the private placement, e.g., Litzler v. CC Investments, L.D.C. (S.D.N.Y. 2006).
- Utilizing their own counsel instead of sharing one counsel, including separately communicating with the company and its counsel – even if comments are coordinated through counsel to one investor for purposes of efficiency, ideally at the company's request, e.g., Litzler.
- Including provisions in the transaction agreements documenting that the use of a single purchase agreement is for the convenience of the issuer and should not create a presumption that investors are acting as a group, e.g., Greenberg v. Hudson Bay Master Fund Ltd. (S.D.N.Y. 2015)
- Including 9.9% blocker provisions in the terms of securities to avoid becoming a 10% stockholder, e.g., Roth ex rel. YRC Worldwide Inc. v. Solus Alternative Asset Management LP (S.D.N.Y. 2015)
- Delaying exercisability or convertibility of warrants or convertible notes, so that the underlying shares might not be deemed beneficially owned – such as (1) only upon more than 60 days notice (Global Intellicom Inc v Thomson Kernaghan and Co. (S.D.N.Y. 1999)) (2) only until a later date when 10% status is no longer problematic, or (3) when the group would have less than 10%. However, this would not be effective if the securities are acquired with the purpose or effect of changing or influencing the control of the company. Rule 13d-3(d)(1)(i).
- Delaying any sales until six months or more following any matchable purchase, taking into account Rule 16a-2(c), which provides that the transaction that results in a person becoming a

10% stockholder is not subject to Section 16 unless the person is otherwise covered.

- Making independent, non-coordinated decisions to subsequently convert or exercise securities and to sell any underlying shares. In CDI 110.02, the SEC staff advises that group membership terminates once members no longer agree to act together and a member that otherwise holds less than 10% is no longer subject to Section 16. However, in light of case law uncertainty, investors should carefully evaluate relevant facts with counsel before taking this position.

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Background. In March 2020, Genius Brands International, Inc. entered into a securities purchase agreement (SPA), selling convertible notes and common stock warrants to several institutional investors. The conditions to closing included a requirement that the principal existing stockholders, holding 40% of outstanding shares, enter into an agreement to vote in favor of the issuance of securities at a stockholder meeting called to comply with Nasdaq rules as well as a 1-¼ year lockup agreement.

As permitted under Section 16(b), the plaintiff brought suit derivatively on behalf of the company, alleging that the institutional investors constituted a group within the meaning of Section 13(d), which is the relevant standard for 10% stockholder status under Section 16(b), and therefore liable to disgorge "short-swing" profits. Some of the reasons alleged by plaintiff included:

- Prior "alliances" among some investors relating to trading in company securities.
- Past client relationships with the company's investment bank acting as placement agent.
- The appointment of a lead investor, which served as collateral agent and acted on behalf of the other investors.
- The requirement that the company use 75% of gross proceeds of any future stock issuance to redeem the convertible notes "on a pro-rata basis."

In June 2020, the investors agreed to convert their notes into shares and to refrain from selling those shares for less than $2 per share for thirty days, subject to an exception.

In the second quarter of 2020, the investors converted their notes and exercised many of their warrants, acquiring approximately 100 million shares. Shortly thereafter, the company issued press releases touting future programming that included Arnold Schwarzenegger and Stan Lee's comics. The plaintiff alleged that the press releases were "designed to generate investor interest to facilitate the sale" of stock issued in the conversion "rapidly and profitably."

Court's Analysis. Section 16 rules provide that for purposes of determining 10% stockholder status, a person will be deemed a beneficial owner as determined pursuant to Section 13(d). Section 13(d)

provides that a person includes a "group" formed for the purposes of acquiring, holding, voting or disposing of shares.

For purposes of the motion to dismiss, the court viewed the allegations in the light most favorable to plaintiff. Using that standard, the court concluded that the complaint plausibly pled that the investors reached an understanding to act in concert, and therefore constituted a "group," based on allegations that:

- Some of the investors had prior relationships with each other or the company's placement agent.
- The investors appointed a lead investor to negotiate and oversee the agreement to acquire convertible notes and warrants at a specified price.
- They entered into a single agreement – the SPA – which required equal treatment of investors, such as *pro rata* redemption of notes.
- As a condition to closing, the agreement required that the controlling stockholders enter into voting and lockup agreements.
- The investors quickly converted and exercised the securities before the company issued the press releases and entered into a leak-out agreement with each other, shortly thereafter selling their shares.

The court acknowledged that the allegations had not been proven but ruled they were sufficient to deny the motion to dismiss. The court rejected the investors' argument that the plaintiff had not cited any evidence of communications among defendants, ruling that such evidence was not required for a motion to dismiss – only at summary judgment or at trial, after discovery.

The court also rejected the investors' argument that the plaintiff had not substantiated that they constituted a 10% stockholder both at the time of purchase and sale of shares. It cited allegations that group was formed in connection with negotiation of the SPA and therefore did not need to consider the fact that the investors did not purchase shares after May 2020. The court did not consider the principle that the purchase which makes a person a 10% stockholder is not subject to Section 16(b).

The court also did not address the Rule 13d-6(b)(2) exemption referenced above, presumably because of the allegations of other indicia of coordinated agreement among investors.

MEET THE TEAM

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