



2-1-1980

# Security Holders' Registration Rights under the Proposed Federal Securities Code: A Current Concern

Larry D. Soderquist

Follow this and additional works at: <http://scholarship.law.nd.edu/ndlr>



Part of the [Law Commons](#)

## Recommended Citation

Larry D. Soderquist, *Security Holders' Registration Rights under the Proposed Federal Securities Code: A Current Concern*, 55 Notre Dame L. Rev. 390 (1980).

Available at: <http://scholarship.law.nd.edu/ndlr/vol55/iss3/5>

This Commentary is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact [lawdr@nd.edu](mailto:lawdr@nd.edu).

## Security Holders' Registration Rights Under the Proposed Federal Securities Code: A Current Concern

Larry D. Soderquist\*

### I. Introduction

Congress will soon begin considering the Federal Securities Code<sup>1</sup> approved by the American Law Institute in May 1978. Although it is dangerous to prognosticate Congressional actions, the Code stands a reasonable chance of passage. During the eight years the Code was being drafted,<sup>2</sup> and in the months following ALI approval, the organized bar and legal commentators have worried over the Code and argued it out at length.<sup>3</sup> Individual practitioners, on the other hand, have generally taken a more passive approach. But at least with respect to one set of provisions, those relating to the rights of security holders to demand "registration" of their securities, the time has come to do corporate planning with the Code in mind.

### II. Registration Rights Under the Code

Under the concept of *control* currently found in section 2(11) of the Securities Act of 1933, one in a control relationship with an issuer—a director for example—is considered to be an issuer for the purpose of determining who is an underwriter.<sup>4</sup> The basic effect of this provision is to make a section 4(1) exemption (covering transactions by any person other than an issuer, underwriter or dealer) generally unavailable to a controlling person—unless rule 144 is complied with—since a sale by a controlling person will likely involve an

---

\* Associate Professor of Law, University of Notre Dame. B.S., Eastern Michigan University, 1966; J.D., Harvard University, 1969.

1 ALI FED. SEC. CODE (Proposed Official Draft, 1978) [hereinafter cited as the CODE].

2 Drafting began in late 1969, with Professor Louis Loss as reporter for the project. *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345, 347 (1978). The beginnings of the project were three years earlier, at a conference on codification sponsored by the Section of Corporation, Banking and Business Law of the American Bar Association. See *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793 (1967). From 1969 through 1978 the Code went through six tentative drafts, with the first issued in 1972.

3 For example, after each tentative draft of the Code was issued, Professor Loss met with the Federal Regulation of Securities Committee of the Section of Corporation, Banking and Business Law of the American Bar Association to review these drafts. *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345, 346 (1978) (comments of Bialkin). After the Proposed Official Draft of the Code was approved by the ALI, Professor Loss again met with Federal Regulation of Securities Committee to discuss the Code. In November 1978 the Committee voted to approve the Code and to recommend it to the Council of the Section. In December 1978 the Council voted its approval. For published reports of two of the meetings between Professor Loss and the Section, see *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345 (1978); Loss, *The Current Status of SEC Codification*, 26 BUS. LAW. 555 (1970). For the most complete treatment of the Code by commentators, see *Symposium: The American Law Institute's Proposed Federal Securities Code*, 30 VAND. L. REV. 311 (1977); and *Symposium: The American Law Institute's Proposed Federal Securities Code*, 32 VAND. L. REV. 457 (1979).

4 Section 2(11) is the definition of "underwriter." The last sentence of this section provides: "As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." 15 U.S.C. § 776(11) (1976).

underwriter.<sup>5</sup> If rule 144 is not available for a transaction that a controlling person contemplates, the controlling person must persuade the issuer to register the securities he wishes to sell. A noncontrolling person, on the other hand, may generally sell securities, other than those purchased in a private placement under section 4(2) of the Securities Act, freely under section 4(1); he needs no right to have his securities registered.

The concept of control has always been a troublesome one,<sup>6</sup> and the Code would appropriately do away with it. The Code would accomplish this by treating all security holders alike when they wish to sell. Basically, no distribution of securities could be made by any person unless an offering statement had been filed with the Securities and Exchange Commission.<sup>7</sup> Under the Code, a distribution would be involved if a security holder sold in other than a limited offering or a trading transaction,<sup>8</sup> or unless the sale fell within one of the Code's transaction exemptions.<sup>9</sup> The most useful of these exemptions would be the small offering exemption and the local distribution exemption. The small offering exemption would provide freedom of sale, without issuer registration or the filing of an offering statement, for offerings of up to \$100,000 (or up to a maximum below \$100,000, but of not less than \$50,000, set by a rule of the SEC).<sup>10</sup> The local distribution exemption, a corollary of Securities Act section 3(a)(11) and rule 147, would allow exempted resales, under certain conditions, of securities purchased in qualified local distributions.<sup>11</sup> A limited offering is the Code corollary of the Securities Act private placement, and the Code would allow limited resales by the initial purchasers.<sup>12</sup> For a sale to be a trading transaction, it would have to be accomplished through a broker, or with or by a dealer, and be within whatever limitations (with respect to dollar amounts, percentage of trading volume or percentage of outstanding securities of the class involved in the sale) the SEC wished to establish.<sup>13</sup> The trading transaction is the Code corollary of a rule 144 sale. Becoming a registrant would be the rough equivalent of having securities registered under section 12 of the Securities Exchange Act of 1934.<sup>14</sup> In the Code, the offering statement takes the place of the Securities Act registration statement.<sup>15</sup>

If the Code did nothing more, this scheme could place substantial transfer restrictions on a minority shareholder who did not, in fact, control a

5 The sale will likely involve an underwriter because, under § 2(11), an underwriter is basically defined as a person who purchases from an issuer with a view to distribution, or who offers or sells for an issuer in connection with a distribution, and because of the special definition of "issuer" referred to in note 4 *supra*. The simplest example is a sale by a controlling person in the public markets through a broker. Here the broker will be an underwriter because he is selling for an "issuer." Since the transaction involves an underwriter, the § 4(1) exemption is not available. 15 U.S.C. § 77d(1) (1976).

6 See, e.g., Sommer, *Who's "in Control"?*—SEC, 21 Bus. Law. 559 (1966).

7 CODE § 502(a).

8 CODE § 242(a).

9 These exemptions generally find their base in the Securities Act exemptions, and cover, for example, such transactions as sales to underwriters (CODE § 512(a)), sales by brokers and dealers (CODE §§ 512(b), (c)), judicially or administratively approved transactions (CODE § 512(f)), sales within the limits of a "small offering" exemption (CODE § 512(e)) and sales that are part of a "local distribution" (CODE § 514).

10 CODE § 512(e).

11 CODE § 514.

12 CODE § 242(b).

13 CODE § 242(c).

14 See CODE §§ 299.40, 401-406.

15 See CODE §§ 299.14, 502(c).

nonregistrant issuer. Except within dollar amounts or percentage limitations set by the SEC for trading transactions, and except for sales within the narrow boundaries of a limited offering or within the limitations of an exempted transaction, such a person could not sell securities unless he persuaded the issuer both to become a registrant and to file an offering statement.<sup>16</sup> The Code solves this problem by providing that any security holder who wishes to make a distribution may demand that an issuer become a registrant and file an offering statement.<sup>17</sup> In order to ease the burden on the issuer, the security holder making such a demand would be required to deposit with the issuer the reasonable estimated expenses involved in the registration and filing, and also to agree to pay on demand any other amounts the issuer expends.<sup>18</sup> (Note that only out-of-pocket expenses seem to be contemplated here.) The issuer then would have sixteen months to comply with the demand,<sup>19</sup> unless the issuer were to make a written offer to buy, at a price it considers fair, the securities that are the subject of the demand (or unless it were to arrange for some other person to make such an offer).<sup>20</sup> The sales price would be as agreed upon by the parties, or a price determined by arbitration if need be.<sup>21</sup>

It should be noted that this demand right provision will have a retroactive effect; if the Code is passed in its present form, security holders will have the demand right no matter when they acquired their securities. One might hope that Congress would insert into the Code a "grandfather clause" protecting pre-Code issuers from the demand right. This hope is probably unfounded: it must be remembered that protecting issuers in this way would leave noncontrolling security holders of nonregistered issuers with substantially more restrictions on their ability to transfer securities than they have under current law.<sup>22</sup> Louis Loss, the major drafter of the Code, has also indicated that failure to provide some right to demand registration might create due process problems.<sup>23</sup>

Giving security holders this demand right, of course, would solve a problem for security holders while creating problems for issuers. Becoming a registrant and filing an offering statement would be expensive and troublesome and would expose the issuer to possible liability.<sup>24</sup> The Code provides that the demanding security holder must pay the issuer's out-of-pocket expenses,<sup>25</sup> but this provision clearly would not cover all of the issuer's expenses. The real cost of lost management time, for example, could be substantial. More importantly, once an issuer were to become a registrant, it would be subject to the same sort of periodic reporting requirements as issuers are now subject to under section 13 of the Securities Exchange Act of 1934.<sup>26</sup> The expense of these re-

16 CODE §§ 403, 502(a).

17 CODE § 502(b)(1).

18 *Id.*

19 *Id.*

20 CODE § 502(b)(6)(C).

21 CODE § 502(b)(7).

22 See text accompanying note 16 *supra*.

23 ALI FED. SEC. CODE § 501, Comment(2) (Text. Draft No. 1, 1972).

24 See generally, CODE §§ 1601-14 (Fraud, Misrepresentation, and Manipulation) and §§ 1701-28 (Civil Liability). For a discussion of liabilities under the Code, see *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345, 380-89 (1978) (comments of Ruder).

25 See note 18 *supra* and accompanying text.

26 See CODE § 602.

quirements would be borne solely by the issuer, and could be avoided only by terminating the registration. This termination could be accomplished ninety days after the end of a fiscal year on which the issuer has under three hundred security holders.<sup>27</sup> Terminating the registration would, however, simply put the issuer again in the position of being subject to security holders' demand rights.

Considering these problems, and considering the extent to which issuers now go to avoid registration under the Securities Exchange Act (for example, by insuring as best they can that they have no more than 499 record shareholders<sup>28</sup>), it is reasonable to expect that issuers would buy out security holders rather than comply with their registration demands. As indicated above, the Code provides for buy outs at an arbitrated price.<sup>29</sup> The problem for the issuer, however, is that paying for a buy out could cripple the company involved, and, in many cases, neither the company nor its other security holders would have funds available to pay for the buy out.

### III. Avoiding Security Holders' Demand Rights

The Code provides solutions to the problem of issuers being forced into registration—but solutions issuers must elect to take advantage of. First, the Code provides that the right to demand issuer registration and the filing of an offering statement may be waived in writing.<sup>30</sup> The Code also provides that the demand right would not be available if contractual or legal restrictions on transfer would be violated by a distribution.<sup>31</sup>

Some restrictions on transfer currently used in connection with private placements and other issuances might make the demand right unavailable. The question, of course, is whether the restrictions would be violated by a distribution. Restrictions vary somewhat, but usual provisions provide that securities may not be transferred unless (1) a registration statement is in effect under the Securities Act or (2) the issuer receives an opinion of counsel that no violation of the Securities Act would be involved in the transfer. It is, of course, problematical as to how these restrictions would be interpreted after the passage of the Code. Some courts might do little more than simply substitute new concepts for old: "Code" for "Securities Act" and "offering statement" for "registration statement." After this were done, it is only a guess as to how the restrictions would be applied. It is reasonable to expect that some courts might hold that these restrictions would not be violated by a distribution, since an issuer would file an offering statement if it complied with a security holder's registration demand. Other courts might find such reasoning somewhat circular.

It is likely that most courts would look at the basic intent of the parties (along with doing an inevitable substitution of concepts). An argument can be

---

27 CODE § 406.

28 Five hundred record holders of a class of equity security is one of the criteria for mandatory registration under Securities Exchange Act § 12(g)(1), 15 U.S.C. § 78l(g)(1) (1976).

29 See text accompanying notes 20-21 *supra*.

30 CODE § 502(b)(6)(A).

31 *Id.*

made that attention to intent should avoid the registration-on-demand requirements when pre-Code transfer restrictions have been agreed upon, since the right to demand registration and the filing of an offering statement would not have been contemplated by the parties. Before reaching this conclusion, however, one must remember that the rights of a noncontrolling security holder to sell without registration would be much more restricted under the Code than under the Securities Act,<sup>32</sup> and many courts would probably be unwilling to force security holders to endure these increased restrictions.

Considering these uncertainties, it would be unwise to rely on the usual type of transfer restrictions to cut off security holders' demand rights under the Code. Currently used restrictive language could, of course, be revised in an attempt to cut off such rights. But this seems a circuitous, and not entirely certain, way to solve a problem that could better be handled in a more straightforward way. That way is, as contemplated by the Code, to obtain express, written waivers of the demand right.<sup>33</sup> There is nothing in the Code to indicate that a waiver of the demand right must be made after the passage of the Code, and there is no apparent reason why this should be so. The only requirements are that the waiver be in writing (the Code says "executed") and that it be express. Considering the real possibility of passage of the Code, issuers should consider having purchasers of securities, and where possible, current security holders who hold some substantial amount of securities (perhaps \$50,000 of any one class),<sup>34</sup> execute waivers of any such demand rights they may be given by the Code.

These waivers should refer specifically to the Code and describe the demand right contemplated in the proposed form of the Code with enough particularity that the waiver is both express and "knowing." The waivers should also be broad enough to cover whatever form such demand rights may take in the final version of the Code, or in federal legislation passed as a derivation from the proposed Code. The following might serve at least as a starting point in drafting a waiver provision for inclusion in a purchase agreement:

The purchaser understands that, under the proposed Federal Securities Code, security holders may be given the right, under certain circumstances, to demand that issuers of securities file "registration statements" and "offering statements" with the Securities and Exchange Commission so that such security holders may make "distributions" of their securities (the terms indicated by quotation marks being defined in said proposed Code). The purchaser is familiar with said proposed Code and with these rights security holders may be given thereunder. With regard to the securities that are the subject matter of this Purchase Agreement, the purchaser hereby waives these rights and any such rights having like effect, whether such rights be as contained in the current proposed version of said Code, whether they be as modified by said Code as finally adopted or later amended, or whether they be as contained in other federal securities legislation.

The Code provides that such a waiver would terminate the demand rights not

---

32 See text accompanying notes 16 and 22 *supra*.

33 CODE § 502(b)(6)(A).

34 This amount being the lowest limit the SEC could set by rule for the maximum small offering exemption under Code § 512(e). See text accompanying note 10 *supra*.

only of the person signing the waiver, but of a subsequent purchaser if (1) the purchaser had knowledge of the waiver or (2) the waiver is noted conspicuously on the security.<sup>35</sup> The obviously sensible course would be to note the waiver on the face of the security.

There should be relatively little problem in convincing prospective security holders to execute such waivers. Although individual purchasers may like having the demand rights themselves, there is good reason for them not to want other security holders to be able to force the issuer to register. Current security holders will present more problems, and it may be difficult to convince many of them to sign waivers. It would be unfortunate, however, if this problem were viewed as substantial enough to draw the support of any issuer or corporate lawyer away from the proposed Code. A discussion of the general benefits of the Code for issuers and corporate lawyers is beyond the scope of this article, but the advantages are substantial and heavily outweigh the problems discussed here.<sup>36</sup> Just being rid of the concept of control is worth a good deal.<sup>37</sup>

---

35 CODE § 502(b)(6)(A).

36 For good discussions of the benefits of the Code, see *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345 (1978); *Symposium: The American Law Institute's Proposed Federal Securities Code*, 32 VAND. L. REV. 457 (1979); *Symposium: The American Law Institute's Proposed Federal Securities Code*, 30 VAND. L. REV. 311 (1977).

37 See notes 4-6 *supra* and accompanying text.