

1938

## CORPORATIONS - INTERPRETATION OF THE "PUBLIC OFFERING" EXEMPTION OF THE FEDERAL SECURITIES ACT AND STATE BLUE-SKY LAWS

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### Recommended Citation

Gerald L. Stoetzer, *CORPORATIONS - INTERPRETATION OF THE "PUBLIC OFFERING" EXEMPTION OF THE FEDERAL SECURITIES ACT AND STATE BLUE-SKY LAWS*, 36 MICH. L. REV. 604 (1938).

Available at: <https://repository.law.umich.edu/mlr/vol36/iss4/5>

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CORPORATIONS — INTERPRETATION OF THE "PUBLIC OFFERING" EXEMPTION OF THE FEDERAL SECURITIES ACT AND STATE BLUE-SKY LAWS — Section 5 of the Federal Securities Act of 1933, as amended,<sup>1</sup> declares that it shall be unlawful to use any means of transportation or communication in interstate commerce or of the mails to dispose of securities or transmit a prospectus thereon unless a registration statement<sup>2</sup> as required by the act is in effect and unless the prospectus<sup>3</sup> meets the statutory requirements. However, certain securities<sup>4</sup> and

<sup>1</sup> 48 Stat. L. 74 et seq. (1933) [as amended, 48 Stat. L. 905 (1934)], 15 U. S. C., § 77a et seq. (1935). Section 5 in part provides: "Unless a registration statement is in effect as to a security, it shall be unlawful for any person . . . to make use of any means of . . . communication in interstate commerce or of the mails to sell . . . such security." 15 U. S. C., § 77e (1935).

<sup>2</sup> 48 Stat. L. 74, §§ 6-8, 26 (Schedule A) (1933), 15 U. S. C., §§ 77f-77h, 77aa (1935).

<sup>3</sup> 48 Stat. L. 74, § 10 (1933) [as amended, 48 Stat. L. 905, § 205 (1934)], 15 U. S. C., § 77j (1935).

<sup>4</sup> 48 Stat. L. 74, § 3 (1933) [as amended, 48 Stat. L. 905, § 202 (1934)], 15 U. S. C., § 77c (1935).

transactions<sup>5</sup> are expressly exempted from application of the act. Among the exemptions set out in section 4 are those "transactions by an issuer not involving any public offering."<sup>6</sup>

While there may be some controversy as to whether the "public offering" or the use of interstate commerce and the mails is the basis of control over the sale of securities under the Federal Securities Act,<sup>7</sup> judicial interpretation of the exemption ("transactions by an issuer *not involving any public offering*"<sup>8</sup>) is imperative.<sup>9</sup> That is, if registration of the securities is not required where no "public offering" thereof is involved, an issuer must be able to determine within what limits he may act without being subjected to statutory liability.<sup>10</sup> "Public offering" is not, however, susceptible of statutory definition;<sup>11</sup> hence, each case must be decided upon its own facts.<sup>12</sup>

Even a so-called "private offering"<sup>13</sup> of unregistered securities

<sup>5</sup> 48 Stat. L. 74, § 4 (1933) [as amended, 48 Stat. L. 905, § 203 (1934)], 15 U. S. C., § 77d (1935).

<sup>6</sup> 15 U. S. C., § 77d (1) (1935).

<sup>7</sup> *Public offering*: Berle, "New Protection for Buyers of Securities," N. Y. TIMES, § 8, p. 1:1 (June 4, 1933): "The point at which control is exercised is the act of offering securities for sale. . . . the act of 'public offering' is made a specific legal test." *Mails*: Douglas and Bates, "Some Effects of the Securities Act upon Investment Banking," 1 UNIV. CHI. L. REV. 283 at 298-299 (1933): "The criterion used throughout the Act is the use of agencies of interstate commerce or of the mails, not public offering. And on that point the Act is in sharp contrast to the English Companies Act. . . . If the standard of public offer were adopted, the Act would follow the English precedent."

<sup>8</sup> 15 U. S. C., § 77d (1) (1935) (italics the writer's).

<sup>9</sup> See James, "The Securities Act of 1933," 32 MICH. L. REV. 624 at 634-635 (1934). The English authorities seem definite: "The 'public' . . . is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole. The point is that the offer is such as to be open to anyone who brings his money." *Nash v. Lynde*, [1929] A. C. 158 at 169. Further, an offering to the public means an offering of shares by the company "to any one who should choose to come in." *Sherwell v. Combined Incandescent Mantles Syndicate*, 23 T. L. R. (Ch. Div.) 482 at 483 (1907).

<sup>10</sup> 48 Stat. L. 74, §§ 12, 20 (1933), 15 U. S. C., §§ 77l, 77t (1935).

<sup>11</sup> Douglas and Bates, "Some Effects of the Securities Act upon Investment Banking," 1 UNIV. CHI. L. REV. 283 at 299-300 (1933). See also, Dodd, "Amending the Securities Act—The American Bar Association Committee's Proposals," 45 YALE L. J. 199 at 205 (1935).

<sup>12</sup> *People v. Montague*, 280 Mich. 610 at 617, 274 N. W. 347 (1937).

<sup>13</sup> Compare blue-sky laws which exempt the offering made to a limited number of persons. Note 23, *infra*. Transactions by an issuer are exempted in order to allow an issuer to make an isolated or specific sale to a certain person. Again, if the sale by the issuer is to the public generally it is within the act. See H. R. REP. § 85, 73d Cong., 1st sess. (1933), p. 16.

through means of interstate commerce and the mails may be violative of the Federal Securities Act if there is a subsequent resale.<sup>14</sup> The business of the initial purchaser, the relation between the issuer and such purchaser, and the time between the private purchase and the proposed resale will be factors determinative of whether in fact there is a "public offering" within the act.<sup>15</sup>

One of the first decisions expressly determining the meaning of the "public offering" exemption under the Federal Securities Act is *Securities and Exchange Commission v. Sunbeam Gold Mines Co.*<sup>16</sup> In that case, the federal Securities and Exchange Commission sought to enjoin the sale of securities of the defendant corporation, offered through the means of interstate commerce and the mails, as a violation of section 5 of the Securities Act.<sup>17</sup> Pursuant to an agreement of merger, the defendant corporation solicited loans in various states from 530 stockholders of the merged corporations by letters offering the securities, termed "shareholders' loan receipts,"<sup>18</sup> which had not been registered with the commission. The United States District Court in Washington held that such transactions did not involve a "public offering" and thus were within the exemption from registration provided for in section 4 (1) of the act.<sup>19</sup> The court held further that, under the particular facts, there was no "public offering," irrespective of the number of stockholders involved. The preliminary injunction was therefore denied.

The blue-sky laws,<sup>20</sup> which antedated the federal act by some twenty years, and the decisions thereunder may be relied upon for aid in interpretation of the exemption herein discussed.<sup>21</sup> Only seven states<sup>22</sup> appear to have expressly exempted, from provisions of the

<sup>14</sup> See excellent comment on the general problem of public offering, 45 YALE L. J. 1076 at 1092-1093 (1936).

<sup>15</sup> See Opinion of General Counsel of Securities and Exchange Commission, Release 603 (Class C), Dec. 16, 1935, C C H Securities Act Service, ¶ 2202.021.

<sup>16</sup> (D. C. Wash. 1937) C C H Securities Act Service, ¶ 2203.12.

<sup>17</sup> See note 1, supra.

<sup>18</sup> These "shareholders' loan receipts" were held by the court in the instant case to be "securities" within the meaning of the Federal Securities Act. Section 2 contemplates this type of paper, for "security" is defined as including "note, stock . . . evidence of indebtedness . . . [and] investment contract." 15 U. S. C., § 77b (1) (1935).

<sup>19</sup> See note 8, supra.

<sup>20</sup> For a correlation of the state and federal acts, see Smith, "State 'Blue-Sky' Laws and the Federal Securities Acts," 34 MICH. L. REV. 1135 (1936).

<sup>21</sup> That is, since "public offering" is not defined in the Federal Securities Act, analogous decisions under the blue-sky laws form the only precedents from which conclusions herein can be drawn.

<sup>22</sup> Alabama, California, Colorado, Michigan, Nebraska, Oregon and Washington. Ohio and West Virginia have provisions suggestive of such an exemption.

respective blue-sky laws requiring licensing or registration, transactions not involving a "public offering." Others have a similar exemption in the event that the offering is made to a limited number of incorporators.<sup>23</sup> Some states exempt the issuance of securities in conjunction with mergers or reorganizations.<sup>24</sup> Still another group of states<sup>25</sup> exempt the sale or distribution of securities to existing stockholders of the issuing corporation. This was the situation in the *Sunbeam Gold Mines* case; there was also the element of merger or consolidation. But there is no specific exemption in the federal act relative either to an offering to existing stockholders or to an issuance of securities in a merger transaction.<sup>26</sup> Almost all of the states,<sup>27</sup> as the converse of the "public offering," exempt isolated transactions and individual sales by bona fide owners in investment, as contrasted with speculative, transactions. At least five states<sup>28</sup> exempt stock subscriptions where no expense is involved in marketing the securities.

The conclusion to be drawn from the various exemptions made in the blue-sky laws is that securities that are not likely to fall into the hands of the general public, or that are so offered that there is little likelihood of fraud upon the public, are exempt from control. The broad purpose of the Federal Securities Act is similar.<sup>29</sup>

Under the Federal Securities Act and under those blue-sky laws with comparable provisions, it would seem that there could be no escape from disclosure requirements though the *sale* is private, if the

<sup>23</sup> Iowa, Michigan, Missouri, Montana, North Dakota and Pennsylvania.

<sup>24</sup> Alabama, Florida, Georgia, Idaho, Illinois, Massachusetts, Missouri, Nebraska, North Carolina, North Dakota, Ohio, Oklahoma, Utah, Vermont and West Virginia.

<sup>25</sup> Arkansas, Illinois, Indiana, Iowa, Louisiana, Michigan, Mississippi, Oklahoma, South Carolina, South Dakota, Utah and West Virginia.

<sup>26</sup> See Federal Trade Commission, Release 97, part 5, Dec. 28, 1933; C C H Securities Act Service, ¶ 2203.4. The exempted securities and transactions are stipulated in sections 3 and 4 respectively. In the exempted transactions the emphasis is placed on the distributor rather than the purchaser. 15 U. S. C., §§ 77c, 77d (1935).

<sup>27</sup> At least thirty-five states have this express exemption. The other states either have no specific exemptions or are of such a type that exemptions are not made. See Smith, "The Relation of the Federal and State Securities Laws," 4 LAW & CONTEMP. PROB. 241 at 242 (1937), for a discussion of the various types of blue-sky laws.

<sup>28</sup> Iowa, Mississippi, North Carolina, Oklahoma and Vermont.

<sup>29</sup> See James, "The Securities Act of 1933," 32 MICH. L. REV. 624 (1934). The requirements of disclosure are intended to prevent fraud and deceit upon the purchaser, fraudulent interstate transactions being declared unlawful in section 17 [48 Stat. L. 74 (1933), 15 U. S. C., § 77q (1935)].

"The theory of the Securities Act of 1933 is that the proper governmental function in connection with the transactions in securities is to prevent fraud by requiring a disclosure to prospective purchasers of all material facts relative to an offering." Smith, "The Relation of the Federal and State Securities Law," 4 LAW & CONTEMP. PROB. 241 at 253 (1937).

offering is public.<sup>30</sup> An offering, such as through a prospectus,<sup>31</sup> letters or personal contacts to persons whose names were secured from stockholder lists of other corporations,<sup>32</sup> or from a "sucker list,"<sup>33</sup> would surely constitute a "public offering."<sup>34</sup> But an offering made solely to existing stockholders of the issuing corporation or merged corporations as in the *Sunbeam Gold Mines* case would logically seem to be without the realm of "public offering."<sup>35</sup> Likewise, a bona fide offer to actual employees of the issuer would be within the exemption.<sup>36</sup>

An offer to an insubstantial number of persons might be within

<sup>30</sup> *Black v. Solano Co.*, 114 Cal. App. 170, 299 P. 843 (1931).

<sup>31</sup> A survey has revealed that most states would not hold that a newspaper prospectus or advertisement constituted a "public offering." Smith, "State 'Blue-Sky' Laws and the Federal Securities Acts," 34 MICH. L. REV. 1135 at 1144 (1936). That fact is of little value here, however, as the Federal Securities Act, section 2, implicitly provides that a newspaper prospectus is not within the meaning of prospectus as used in the act, if it states from whom a prospectus meeting requirements of the act may be obtained and if it "does no more than identify the security, state the price thereof, and state by whom orders will be executed." 15 U. S. C., § 77b (10) (1935). See Smith, "The Relation of the Federal and State Securities Law," 4 LAW & CONTEMP. PROB. 241 at 250 (1937). Cf. *Robertson v. Business Boosters' Country Club*, 212 Ala. 621, 103 So. 576 (1925).

<sup>32</sup> "An offer to sell to parties selected from a list of stockholders of a corporation is no more a private offering than if names had been selected from a city or telephone directory, or taken from a list supplied by those in the business of selling such information." *People v. Montague*, 280 Mich. 610 at 617, 274 N. W. 347 (1937).

<sup>33</sup> "An offering of securities is 'to the public' even though the effort to sell be limited to that portion of the public proven by experience to be particularly susceptible to such offers." *Mary Pickford Co. v. Bayly Bros., Inc.*, (Cal. App. 1937) 68 P. (2d) 239 at 243.

<sup>34</sup> This assumes that the purpose of the Federal Securities Act is to protect the public from its own folly. See note 29, *supra*.

<sup>35</sup> Even though the same purpose is assumed, the evil sought to be avoided would logically be eliminated since existing stockholders are familiar with or have the opportunity to be familiar with the internal affairs of the corporation. *Securities & Exchange Commission v. Federal Compress & Warehouse Co.*, (D. C. Tenn. 1936) unreported, dismissal stipulated (C. C. A. 6th, 1936) 88 F. (2d) 1018, C C H Securities Act Service, ¶ 2203.09.

However, compare: "An offering confined to the security holders of a corporation may nevertheless be a 'public offering' within the meaning of section 4 (1)." Federal Trade Commission, Release 98, part 6, Dec. 28, 1933, C C H Securities Act Service, ¶ 2203.05.

In *People v. Ruthven*, 160 Misc. 112, 288 N. Y. S. 631 (1937), noted 46 YALE L. J. 1071 (1937), it was held that sales to stockholders did not constitute sales to the public.

<sup>36</sup> A majority of the drafting committee was of the opinion that such an offering would not be a "public offering." An amendment expressly exempting transactions with employes was proposed but abandoned, no doubt because of the Insull manipulations. See 78 CONG. REC. 10181 (1934).

the exemption,<sup>37</sup> but the question of a "public offering," considering the apparent purpose of the act, cannot be determined exclusively by the number of the prospective offerees.<sup>38</sup> Certain factors may be categorically stated as to the availability of the exemption: (1) number of offerees, relations inter se and with the issuer;<sup>39</sup> (2) number of units of securities offered;<sup>40</sup> (3) size of the offering;<sup>41</sup> (4) manner in which the offering is made;<sup>42</sup> and (5) likelihood of present or subsequent injury to the public through an influx of unregistered speculative securities.<sup>43</sup>

However, it is submitted that attempted avoidance of registration of an issue otherwise subject to the Federal Securities Act is not justified even where the particular transaction may be construed as not involving a "public offering," because of the practical difficulty that

<sup>37</sup> An offer to two persons has been held not to involve a "public offering." *Gillespie v. Long*, 212 Ala. 34, 101 So. 651 (1924).

"By 'sales to the public' it is not meant that there need be offers or sales to all of the people, but only that there be offers or sales to many of them as contradistinguished from a few." 22 CAL. L. REV. 341 at 347 (1934).

<sup>38</sup> Opinion of General Counsel of the Securities & Exchange Commission, Release 285, Jan. 24, 1935, C C H Securities Act Service, ¶ 2203.021.

<sup>39</sup> In determining what constitutes a substantial number of offerees, the basis of selection is important. Further, an offering to a class having special knowledge (such as executives as contrasted with employees) would be less likely to be a "public offering" than one to members lacking this advantage. C C H, op. cit., note 38; and cf. note 34. As for the number of offerees, cf. notes 9 and 37.

<sup>40</sup> Under this test, questions of denominations, convertibility, possibility of public distribution and concurrence with the offer of other securities by the same issuer must be considered. C C H, op. cit., note 38.

<sup>41</sup> A small offering is less likely to be publicly offered even if there is a redistribution. There is always present the question whether a public distribution is at all likely within a reasonable time. C C H op. cit., note 38.

Blue-sky laws: Iowa, Nebraska, Pennsylvania, Vermont and Wyoming make exemptions where there is a stipulated offering limited in amount.

<sup>42</sup> Transactions consummated by the direct negotiations of the issuer are less likely to be "public" than those effected through the mechanics of public distribution. C C H, op. cit., note 38.

Where there was a general scheme to float a large issue through a series of transactions, the offer and sale being to any persons who could be induced to invest, there was held to be a "public offering." *In re Leach*, 215 Cal. 536, 12 P. (2d) 3 (1932).

A letter informing purchaser that he could procure similar securities for his friends was held to evidence a "public offering." *State v. Whiteaker*, 118 Ore. 656, 247 P. 1077 (1926).

The Ohio Securities Act exempts commercial paper not offered for sale to the public. An issuance of notes to *anyone* who "came in and put their money down for them," including stockholders and friends was held not exempt. *State v. Weger*, (Ohio App. 1937), C C H Securities Act Service, ¶ 2202.12.

<sup>43</sup> That is, there should be considered the intent of the purchaser, whether for purchase or resale.

the purchasers may have in redistributing securities which were originally issued without registration in reliance upon this exemption.<sup>44</sup> Thus the possibility in the *Sunbeam Gold Mines* case that the securities issued to existing stockholders might be transferred to the general public would have justified a holding that there *was* a "public offering." On the other hand, the very nature of the securities in that case, "shareholders' loan receipts," justifies the result reached, for such securities are not at all likely to be transferred to the general public, nor would the public be likely to be interested therein.

Because of the various factors herein discussed, a conclusion may not be justifiably reached, however, that no offer of securities to existing stockholders of the issuing or merged corporations would constitute a "public offering." For the same reason, that there are innumerable and varied considerations involved in each case as it arises, it does not appear to be necessary, proper or, in fact, feasible to define dogmatically a "public offering" as applicable to exceptions under the Federal Securities Act or the blue-sky laws.

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<sup>44</sup> In general on exemptions, see Throop and Lane, "Some Problems of Exemptions under the Securities Act of 1933," 4 *LAW & CONTEMP. PROB.* 89 (1937).