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## THE "GOING PUBLIC THROUGH THE BACK DOOR" PHENOMENON — AN ASSESSMENT

By RONALD M. SHAPIRO\* and LAURENCE M. KATZ\*\*

Substantial stockholders in privately held corporations must frequently weigh the advantages and disadvantages, either real or supposed, of "going public." They seek the glamour and financial gain of being significant stockholders in, or management of, a company whose securities appear in the "pink sheets" and are publicly traded. At the same time, they are somewhat dismayed when they explore the three traditional requirements which generally must be met in order to go public.

First, an underwriter must be found who is willing to distribute the stock publicly through that underwriter's market-making channels.<sup>1</sup> Even if such a contact is made and intentions to underwrite are expressed, uncertainty may persist as to whether, in fact, the investment banker will ultimately underwrite a public offering of the stock. Generally, underwriters do not legally bind themselves to undertake a financing until immediately preceding the commencement of an offering. Furthermore, even if the underwriting is obtainable, the cost may involve not only the traditional underwriting "spread," but also distribution to the underwriter of "cheap stock" or significant amounts of "warrants and options."<sup>2</sup>

Secondly, securities attorneys and independent accountants must be retained to "clean up" the corporation for a public offering and to prepare the necessary filings, perhaps along with underwriters' attorneys, for registration with the Securities and Exchange Commission.<sup>3</sup> This step not only may involve incurring sizable fees, but also opens the management of the private corporation to a searching

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1. It is possible "to go public" without engaging the services of an underwriter; a private company may make a non-underwritten direct offer of its stock through some kind of public offering process, be it on a limited basis via a Regulation A exemption filing or a full-blown registration. Nevertheless, there are dangers inherent in attempting to go public in this non-underwritten manner which include improper market coverage for the securities offered and a lack of back-up financing support for the company.

See G. ROBINSON, GOING PUBLIC §§ 1-47 (1961), for a rudimentary discussion of the preliminary considerations and practical mechanics of underwriting pursuant to going public.

2. It should be emphasized that the security brokerage profession as a whole displays the utmost integrity in its work. Nevertheless, the private company seeking public status is often confronted with no buyers in the legitimate securities investment banking market place. Hence it is forced to make contact with underwriters whose methods of underwriting and demands on their clients are somewhat questionable.

3. It is possible that the existing corporate counsel has securities experience and therefore the services of outside securities specialists will not have to be retained. It should, however, be pointed out that the expense of legal services in connection with a registration statement and subsequent public offering runs into more hours and higher expense than traditional corporate legal work.

liability investigation by the attorneys which may prove offensive to its closed corporation sensibilities.

Thirdly, the private about-to-be public corporation must undergo the time-consuming SEC registration process required by the Securities Act of 1933<sup>4</sup> (the Act). Such a process may currently take more than three months and often tries the patience of the public-looking private management which has never been faced with the rigors of SEC regulation and desires to get into the market as quickly as possible.<sup>5</sup>

Confronted with such a maze of uncertainty, potential costs, legal probity, and delay, private corporate management may seek to attain public status through a back door which ostensibly need not be opened by the keys of underwriters, legal and financial securities specialists, and SEC registration. More accessible, and perhaps more familiar, keys may provide an easier route to the goal of being public. The cooperation or control of an available and quiescent public corporate shell or of a public operating company, combined with any one of several familiar corporate techniques such as mergers and spin-offs may be the only keys necessary to enter the public securities market. Although those using these techniques will probably not be raising funds for the corporation, they seem to believe that, at a lesser cost and with less difficulty, they have made financing on a private or public basis more readily accessible in the future and have enhanced the value and the marketability of their own stock.

Despite the apparent simplicity and appeal of these methods of entry to public status, it must be asked whether that entrance opens onto a rocky road involving serious legal and practical problems. Will the corporation that has gone public in this manner find that its technique has led it into the dangerous realm of possible securities act violations? Furthermore, will the corporation have lost something by not taking the traditional route to public status, assuming it was, on some basis, intrinsically worthy of achieving such status; or in other words, has it gone public merely for going public's sake? This article will discuss the answers to these questions and will analyze the legal and practical implications of certain devices employed by private corporate management to enter the public company realm by other than traditional means.

### I. BASIC DEVICES FOR "GOING PUBLIC" WITHOUT SECURITIES ACT REGISTRATION

Three typical transactions include the basic elements of the varying techniques being used to bring corporations public without either Securities Act registration or underwriter involvement.

*Example A. Sale of Shares to Public Corporation and Public Corporation Distribution Thereof to Its Shareholders.* Pri-Corp is

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4. 15 U.S.C. § 77(a)-(aa) (1965).

5. There is a possibility, under current SEC practice, that a registration statement filed with the SEC will receive so-called "expedited treatment" and that the registration process as a result thereof can be as brief as twenty-five days. Such expeditious handling of registration statements received from corporations about to go public for the first time, however, is highly improbable.

a privately held and somewhat successful company. It has been profitable for its few owners. During its operating history, it has had no need to disclose and has not in fact released general and financial information concerning its operations. Pub-Corp is a publicly held operating company and its stock is actively traded over the counter. Pri-Corp arranges a transaction in which Pub-Corp will transfer some nominal asset<sup>6</sup> to Pri-Corp in exchange for a non-control percentage of Pri-Corp shares. Pub-Corp then issues most of the Pri-Corp stock it has acquired to Pub-Corp shareholders as a dividend, so that a portion of Pri-Corp stock is now in the hands of the numerous Pub-Corp shareholders. Subsequent sales by those shareholders will then create a public market in Pri-Corp securities.

*Example B. Mass Produced Spin-Offs.* Pub-Corp is a publicly held corporation which was organized for uranium exploration in the early 1960's during the uranium boom, and which became inactive shortly thereafter for lack of uranium finding success. The outstanding stock of Pub-Corp was traded over the counter for several years and is in the hands of thousands of shareholders. Its trading activity has been quiescent for some time. A group of promoters has taken control of Pub-Corp and offers the opportunity to go public to all private corporations willing to give to Pub-Corp stockholders a portion of their stock. Stock of Pri-Corp is transferred to this inactive Pub-Corp, as in *Example A*, and part of these shares are transferred as a dividend or spun off to Pub-Corp shareholders. In other words, *Example B* is the same as *Example A* except that the Pub-Corp is not an operating company. As will be discussed later, this difference between the two examples may make some difference in the legality of non-registration. After the spin-off to Pub-Corp shareholders, Pri-Corp now has a percentage of its stock in the hands of thousands of public shareholders and has "gone public."<sup>7</sup>

*Example C. Merger or Other Combination with a Shell Subsidiary of the Public Company.* Pub-Corp, an operating public company, spins off the stock of its subsidiary, Sub-Pub-Corp, as a dividend to its shareholders. Sub-Pub-Corp has been a "shell" with little or no assets. Pri-Corp arranges a transaction through which Pri-Corp is merged into Sub-Pub-Corp with former Pri-Corp management acquiring control of the new Sub-Pub-Corp organization. Pri-Corp management has thus transferred the assets of Pri-Corp into the public shell in exchange for the controlling interest in that shell. In effect, Pri-Corp, now existing within the shell of Sub-Pub-Corp, has numerous shareholders who may trade the formerly private stock of the company in the over-the-counter market.<sup>8</sup>

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6. State corporate statutes generally require some consideration for such transfers. See note 9 *infra*.

7. Mass-produced spin-offs have also been called "popcorn spin-offs" because the stock of the private corporation is exploded out to the shareholders of the public corporation in much the same way that the vendor's popcorn kernels explode from dormancy in the bottom of a cooker into the hands of the buying public.

8. The appellations Pri-Corp, Pub-Corp and Sub-Pub-Corp will be continued throughout the text without footnote treatment. Likewise, future references to *Examples A, B* and *C* are to those hypothetical situations just outlined.

Although numerous variations on the techniques in the above examples may be used to achieve public status, these examples appear to be the basic forms of transactions which have been used to avoid both Securities Act registration and underwriter participation. In addition they raise all of the basic securities law problems which would confront anyone attempting to go public through the back door.<sup>9</sup>

## II. THE REGISTRATION PROBLEMS OF THE PRIVATE SALE/SPIN-OFF TECHNIQUE

The registration provisions of the Securities Act of 1933 are designed to protect investors by promoting full disclosure of information in the interstate distribution of securities where the securities are publicly offered for sale by an issuing company or by a person in control of such company. Disclosure is sought by requiring the issuer of such securities to file with the Securities and Exchange Commission a registration statement, including a prospectus, containing relevant financial and other information about the company's business and management and about the offering. The core provision of the Act is Section 5<sup>10</sup> which, among other things, prohibits any sale of a security in interstate commerce unless a registration statement is in effect. While Section 5 is absolute on its face, it is modified by Sections 3<sup>11</sup> and 4<sup>12</sup> of the Act which exempt certain securities and certain transactions from the registration requirements.

Traditionally, the framers of transactions such as those described in *Examples A* and *B* (private sale/spin-off methods), rather than comply with the registration and prospectus requirements, have sought refuge from full disclosure behind one of these exemptions. It is obvious, however, upon execution of either of these non-registration techniques, that Pri-Corp's securities will have been placed in the hands of the public without the disclosure of adequate information about Pri-Corp. The Securities and Exchange Commission, in a recent release,<sup>13</sup> has questioned whether such private sale/spin-off devices should be exempt from registration. The Commission noted that

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9. As a fourth possibility, Pri-Corp may transfer its assets for a controlling interest in Pub-Corp stock. While such a technique may not present the problems discussed in part III *infra*, it would be subject to the anti-fraud implications of part IV *infra*.

Suggestions have been made that a private company might go public (for the sake of going public) by merely mailing a portion of its stock to all of the residents of the town of Haverford, Pennsylvania. Such a mailing device, clearly involving no sale of securities, certainly would achieve the goal of placing stock in public hands without the securities problems discussed herein. See parts II and III *infra*. This transaction, however, raises serious problems from the standpoint of state corporate law because of the general statutory requirements that issuance by a corporation of its stock must be for consideration. *E.g.*, DEL. CODE ANN. tit. 8, §§ 152, 153 (1953); MD. ANN. CODE art. 23, § 20(c) (1966). Of course, once consideration, even if nominal, enters the picture, so does a sale, and the Securities Act registration provisions become operative.

Other than in the context of this footnote, state corporate law problems have not been discussed in this article.

10. 15 U.S.C. § 77(e) (1964).

11. *Id.* § 77(c).

12. *Id.* § 77(d).

13. SEC Securities Act Release No. 4982 (July 2, 1969).

"[d]evices of this kind, contravene the purpose, as well as the specific provisions, of the Act which, in the words of the statutory preamble, are 'to provide full and fair disclosure of the character of the securities sold in interstate and foreign commerce and through the mails and to prevent frauds in the sale thereof.'"<sup>14</sup> In the view of the Commission, the circumstances of a spin-off by Pub-Corp followed by active trading in Pri-Corp's stock, all in the absence of information about Pri-Corp, create a potential for fraud and deceit.<sup>15</sup>

Despite the jaundiced view of *Example A* and *B* type transactions expressed by the Commission in the release, those continuing to use these techniques persist in their view that registration is not required. Their claim to legality rests on the assertion that the private sale/spin-off fits within the mold of two separate transactions, neither of which is subject to registration. The first transaction is the sale by Pri-Corp (the issuer) of its securities to Pub-Corp. This sale, it is contended, is exempt under Section 4(2) of the Act as a non-public, private offering.<sup>16</sup> The second transaction is the distribution by Pub-Corp of the issuer's securities as a dividend to the Pub-Corp stockholders. Here it is claimed that the registration requirements of the Act do not apply since no "sale" has taken place to make the requirements operative.<sup>17</sup>

The private offering exemption of Section 4(2), the basis for seeking to exempt the sale of Pri-Corp's stock to Pub-Corp, appears on its face to be deceptively simple; the gloss, however, is substantial. This provision exempting transactions by an issuer which do not involve any public offering was included in the Act on the theory that the Act's registration and prospectus protections are unnecessary where securities are offered to sophisticated investors; rather they are only required where offerings thereof are made to members of the general public.<sup>18</sup> To qualify for the Section 4(2) exemption securities must "come to rest" in the hands of qualified offerees.<sup>19</sup> The initial offering must be private. Furthermore, if the securities are taken by a person who has purchased with a view to or in connection with a distribution of any security, that person will be deemed a statutory underwriter and the entire offering will lose its exempt status.<sup>20</sup> Thus, if the initial offerees in an ostensibly private offering re-offer their

14. *Id.*

15. *Id.*

16. 15 U.S.C. § 77(d)(2) (1964). This section exempts from registration all "transactions by an issuer not involving any public offering."

17. 15 U.S.C. § 77(b)(3) (1964), gives the statutory definition of sale.

18. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 37 (1959).

The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government. That bureaucracy, untrained in these matters as it was, could hardly equal these investors for sophistication, provided only it was their own money that they were spending.

19. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

20. At the outset it should be understood that if securities are first offered and sold to qualified offerees and at a somewhat later date additional securities are offered to non-qualified offerees, then the entire series of transactions may be "integrated" into one public "issue" and the exemption lost. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

securities to the public they may be deemed "underwriters" and the issuer's *initial offering* will be viewed as a public offering. This rule is sometimes stated as a requirement that the initial offerees take from the issuer with "investment intent."

The search for a usable standard to determine who is a proper offeree under Section 4(2) has been difficult. The legislative history of the exemption adds little to the meaning of "private offering."<sup>21</sup> The void was initially filled by a 1935 General Counsel's opinion issued in a Commission release.<sup>22</sup> The release noted that opinions had been expressed by the General Counsel's office that an offering "to an insubstantial number of persons is a transaction by the issuer not involving any public offering" and that "under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number. . . ."<sup>23</sup> The release cautioned, however, that qualifications for the exemption could not be determined exclusively by the number of offerees and that to qualify it was necessary to examine all of the "surrounding circumstances." Among the circumstances to be examined were (1) the number of offerees and their relationship to each other and to the issuers, (2) the number of units offered, (3) the size of the offering, and (4) the manner of the offering.

Despite the broad scope of the surrounding circumstances concept, the number of offerees and their relationship to the issuer predominated as the crucial private offering criteria.<sup>24</sup> Moreover, it was generally accepted as a rule of thumb that an offering to twenty-five or less was exempt.<sup>25</sup> It may be, however, that under some circumstances even a sole offeree may not be a qualified offeree. Thus, consideration of the cases which have applied principles other than numbers is important.

In *SEC v. Sunbeam Gold Mines Co.*,<sup>26</sup> Sunbeam contracted to purchase the assets of a second corporation. Pending approval of the agreement by the two companies' shareholders, Sunbeam offered securities to 530 individuals, all of whom were stockholders of either Sunbeam or the second corporation or both. The district court held

21. The reference in the House Report to the exemption as permitting "an issuer to make a specific or isolated sale of its securities to a particular person" has been considered too restrictive to act as a guide to corporate counsel and their clients. Wood, *The Investment-Intent Dilemma in Secondary Transactions*, 39 N.Y.U.L. Rev. 1043, 1046 (1964). See also 1 L. LOSS, *SECURITIES REGULATION* 653 (2d ed. 1961).

22. SEC Securities Act Release No. 285 (Jan. 24, 1935).

23. *Id.*

24. Wood, *The Investment-Intent Dilemma in Secondary Transactions*, 39 N.Y.U.L. Rev. 1043, 1047 (1964).

25. Meer, *The Private Offering Exemption Under the Federal Securities Act — A Study in Administrative and Judicial Contraction*, 20 Sw. L.J. 503, 515 (1966); Orrick, *Some Observations on the Administration of the Securities Laws*, 42 MINN. L. Rev. 25, 33 (1957). See E. THOMAS, *FEDERAL SECURITIES ACT HANDBOOK* 30 (3d ed. 1969), where a warning is given to those practitioners who continue to use this number as a guide, cautioning that "it is unsafe to rely exclusively on numbers," since as the numbers increase the risk of relying upon the exemption increases.

In *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), it was determined that the number of offerees is not conclusive, but "is relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available."

26. 95 F.2d 699 (9th Cir. 1938).

that the offering was not public. In reversing, the Ninth Circuit Court of Appeals accepted the SEC's position that "[s]uch an offering, though not open to everyone who may choose to apply, is none the less "public" in character, for the means used to select the particular individuals to whom the offering is to be made bear *no sensible relation* to the purposes for which the selection is made.'"<sup>27</sup> Although what would be a sensible relation was not made clear, it is apparent that the exemption would not be available where a limited class of offerees was selected merely as a scheme for circumventing the Act.

This "sensible relations" standard was effective insofar as it recognized the danger of establishing artificial classifications merely to avoid the registration requirements of the Act. But the test has been difficult to apply because "at times there might appear to be a sensible relation between the class selected and the purpose of the selection, [and yet] the transaction might not deserve exemption as a private offering."<sup>28</sup>

An illustration of the deficiencies of the "sensible relations" test as a sole guide is found in the landmark SEC action against Ralston Purina Company.<sup>29</sup> Ralston Purina had a history of encouraging stock ownership by its employees. In 1951, the company, claiming the private offering exemption, offered to sell securities without registration to about 500 "key" employees. All parties agreed that an offering to all 7000 employees would have required registration.<sup>30</sup> The company's definition of "key employee" was as follows:

A key employee of course can be an officer or a department head or an assistant to a department head but is not confined to an organization chart. It would include an individual who is eligible for promotion, an individual who especially influences others or who advises others, a person whom the employees look to in some special way, an individual, of course, who carries some special responsibility, who is sympathetic to management and who is ambitious and who the management feels is likely to be promoted to a greater responsibility.<sup>31</sup>

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27. *Id.* at 701 (emphasis added).

28. Wood, *The Investment-Intent Dilemma in Secondary Transactions*, 39 N.Y.U.L. Rev. 1043, 1049 (1964).

29. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), *rev'g* 200 F.2d 85 (8th Cir.), 102 F. Supp. 964 (E.D. Mo. 1952).

30. 346 U.S. at 122.

31. 200 F.2d at 87. The company's reasons for not wanting to register the yearly offering to these employees are understandable. A vice-president and director testified:

The reasons are very definite. Personally, I have been through a registration just once, and when we started to register our preferred stock, we started in January. It took until May 15th before we could get the schedules. It cost us tens of thousands of dollars. Now, when you are putting out an issue, or when you are selling to a group, to a small intimate group, if the sale is between three or four or ten thousand shares and you have to spend for a hundred special accountants' fees, lawyers' fees, printing expenses, travel expenses, clerical expenses — there is a host of expenses in connection with the registration which makes it entirely unwarranted to spend that much money to accommodate key employees. The big factor is a very important factor. We come to the end of the year; we cannot wait 3½ months to know what we are going to do; we have to deal with our employees, pay our bonuses, and make our deals then. If we have to wait for 3½ months, or if we have to wait for 2½ months, which probably would be a pretty fair length of time, and then pay financial extras, legal people, accounting people, printing, long distance telephone and telephone calls, clerical



Based in part on the company's concept of "key employee," the district court concluded that the offering was not public.<sup>32</sup> Relying on *Sunbeam*, it found that "[t]he sole purpose of the 'selection' is to keep part stock ownership of the business within the operating personnel of the business and to spread ownership throughout all departments and activities of the business" and held that "[t]he purpose of the selection bears a 'sensible relation' to the class chosen."<sup>33</sup> The court of appeals affirmed, viewing the transaction as "intra-organizational offerings of stock by the Company, unaccompanied by any solicitation, which have resulted in a limited distribution of stock, for investment purposes, to a select group of employees considered by the management to be worthy of retention and probable future promotion."<sup>34</sup>

The Supreme Court rejected this application of the sensible relations test and found the exemption to be unavailable. It concluded that "[t]he focus of the inquiry should be on the *need* of the offerees for the protections afforded by the registration."<sup>35</sup> In order for the offering to qualify for the exemption, the offerees must be "able to fend for themselves."<sup>36</sup> As an example of a group fulfilling such qualifications, the Court referred to "executive personnel who because of their position have *access to* the same kind of *information* that the Act would make available in the form of a registration statement."<sup>37</sup> So, in addition to having a degree of sophistication, it is critical that the offeree have access to relevant information about the company.<sup>38</sup> It is not sufficient that an unsophisticated offeree acknowledge that such information has been made available to him.<sup>39</sup> Furthermore, the issuer may not avoid otherwise required registration by obtaining a potential purchaser's waiver of the Act's requirement.<sup>40</sup>

With this background it might reasonably be asked whether Pub-Corp fits the legal mold of a qualified offeree in the private sale/spin-off transaction between it and Pri-Corp. An affirmative response to this question is doubtful in the case of *Example B*, where Pub-Corp is a mere defunct shell. Such an empty state of corporate existence may bespeak a general lack of sound business judgment and

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expenses, travel, and pile all that expense on the sale of a few shares of stock to an intimate group, we feel that that is entirely unwarranted, and it is a matter of economy on our part. . . .

*Id.* at 88-89.

32. 102 F. Supp. at 970.

33. *Id.* at 968-69.

34. 200 F.2d at 93.

35. 346 U.S. at 127 (emphasis added). In keeping with the broadly remedial purposes of federal securities legislation, the burden of proving that the initial offerees were all part of a "private" group was placed on the issuer claiming the exemption. *Id.* at 126. See also *Woodward v. Wright*, 266 F.2d 108, 115 (10th Cir. 1959). While the statute contains no numerical limit, the Supreme Court in *Ralston* indicated that the SEC could establish a numerical test in deciding when to investigate. 346 U.S. at 125. The significance of the numbers will vary depending on the nature of the offeree group. See note 25 *supra*.

36. 346 U.S. at 125.

37. *Id.* at 125-26 (emphasis added).

38. See also *In re Gilligan, Will & Co.*, 38 S.E.C. 388, 393 (1958), *aff'd*, 267 F.2d 461 (2d Cir. 1959).

39. *United States v. Custer Channel Wing Corp.*, 247 F. Supp. 481, 489 (D. Md. 1965), *aff'd*, 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967).

40. 376 F.2d at 679; SEC Securities Act Release No. 4552 (Nov. 6, 1962).

financial acumen — qualities requisite for sophisticated investment decisions. Even where Pub-Corp, as in *Example A*, is an operating company, there is no assurance that it has ready access to general and financial information relating to the issuer, Pri-Corp. Pri-Corp presumably has never compiled the type of information about itself and perhaps has never even obtained the certified financial statements usually deemed necessary for informed investment judgments. Moreover, by the very nature of the nominal consideration involved and the spin-off orientation of the transaction, Pub-Corp has no particular incentive to use either its sophistication, if any, its relationship to the issuer, if any, or its access to relevant information, if any. Hence it is highly questionable whether the Pri-Corp/Pub-Corp “private” sale transaction adequately demonstrates the characteristics of a valid private offering exempt transaction.<sup>41</sup>

Even if Pub-Corp were a sophisticated and fully informed purchaser of Pri-Corp shares, the sale of such shares, in *Examples A* and *B*, to Pub-Corp may not be exempt under Section 4(2) because of the lack of investment intent.

The purpose of the exemption of non-public offerings would appear to have been to make registration unnecessary in these relatively few cases where an issuer desires to consummate a transaction or a few transactions and where the transaction or transactions are of such a nature that the securities in question are not likely to come into the hands of the general public.<sup>42</sup>

Thus the SEC and the case law have added the requirement that the offeree must not take “with a view to public distribution.” The very purpose of transactions like those of *Examples A* and *B* is to place Pri-Corp securities in the hands of the general public. The results of such an intention contravene the policy underlying the private offering exemption.

In summary, it is crucial to a successful claim to Section 4(2) exemption status not only that an offering initially be made to qualified offerees, but also that the shares so offered not pass to persons intending to make a distribution thereof. If a purchaser takes the securities with a view to “distribution,” he will be deemed an underwriter within Section 2(11) of the Act, and the issuer will have violated Section 5 of the Act. Moreover, such a statutory underwriter may not distribute securities unless he does so pursuant to an effective registration statement.<sup>43</sup> If he does distribute publicly without regis-

41. The Supreme Court in *Ralston* rejected the lower courts' use of the sensible purposes test and held that even if that test were satisfied the private offering exemption was still unavailable in that case because all of the offerees did not have the ability to fend for themselves. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). While compliance with the sensible relations test may no longer be sufficient to satisfy the private offering exemption, failure to satisfy even that test will certainly bar access to the private offering exemption.

42. SEC Securities Act Release No. 285 (Jan. 24, 1935).

43. Section 4(1) does not exempt underwriters from the registration requirements of Section 5. 15 U.S.C. §§ 77(d)(1), (e) (1964). This does not mean, however, that purchasers in private transactions may never resell. If their subsequent sales are consistent with an original taking for *investment*, as opposed to taking with a view

tration, then the issuer as well may suffer liability, regardless of its lack of knowledge that its purchaser would be a statutory underwriter by virtue of his (the purchaser's) planned distribution.<sup>44</sup> Thus, if such purchaser is deemed a statutory underwriter, the private offering exemption will be lost.

It is necessary, therefore, to determine whether Pub-Corp takes "with a view to distribution": that is, whether its dividend of Pri-Corp shares is a "distribution." While Section 2(11) does not define "distribution," this term has been considered to be "essentially synonymous with public offering."<sup>45</sup> A review of the cases and Commission releases reveals that the existence of a sale to the public has played a key role in the determination of whether a distribution which obviates the Section 4(2) exemption has occurred.

It is clear in the private sale/spin-off transactions of *Examples A* and *B* that Pub-Corp is purchasing from Pri-Corp at least some shares without an intent to hold them for investment. As to these shares it intends to, and ultimately does, transfer them to its shareholders. If this transfer to Pub-Corp shareholders involves a sale, then the initial sale by Pri-Corp to Pub-Corp cannot be an exempt private offering; it is but a step in a "public offering" and violates the registration requirements of the Act. The transfer as framed by the examples and as often cast in practice, however, takes the form of a dividend of corporate portfolio securities. It is argued that the dividend transfer is neither a "public offering" nor a sale and hence not a "distribution."

The ordinary stock dividend does not constitute a "sale" because it is not a disposition for "value."<sup>46</sup> And in isolation the distribution of portfolio securities, whether as dividends or in liquidation, is not subject to registration because of this no sale characterization.<sup>47</sup> But should this rationale apply where the portfolio dividend is only a last step in a transaction designed to achieve private offering exemption?

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to distribution, such purchasers are not *underwriters* and the issuer is only involved in a private transaction with the original purchasers. And a "change of circumstances" requiring resale is not deemed inconsistent with the original investment intent. SEC Securities Act Release No. 4552 (Nov. 6, 1962); Flanagan, *The Federal Securities Act and the Locked-in Stockholder*, 63 MICH. L. REV. 1139, 1153-54 (1965).

44. See *In re Siatron Electronics & Television Corp.*, 40 S.E.C. 236, 245 (1960); SEC Securities Act Release No. 3825 (Aug. 12, 1957) (Crowell-Collier Publishing Co.).

45. See I L. LOSS, *SECURITIES REGULATION* 551 & n.307 (2d ed. 1961); SEC, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 161-62 (1969) [hereinafter cited as WHEAT REPORT].

46. I L. LOSS, *SECURITIES REGULATION* 517-18 (2d ed. 1961); Bromberg, *Corporate Liquidation and Securities Law — Problems in the Distribution of Portfolio Securities*, 3 B.C. IND. & COM. L. REV. 1, 5 (1961).

In SEC Securities Act Release No. 929 (July 29, 1936), the General Counsel indicated that no "sale" took place (1) when a stock dividend is declared by itself (no cash involved) and (2) when stock or cash are offered in the alternative and the taking of either waives the right to the other. The contrary result was indicated when the corporation allows stockholders an option to forego a *declared* cash dividend in favor of a dividend of securities. In that situation the waiver or surrender of the claim to cash constitutes "value" and a "sale" is involved.

47. Cf. Investment Company Act Rule 17a-5 which excludes an investment company's pro rata distribution in cash or kind from the terms "purchase" and "sale" as used in Section 17(a) of that Act if no stockholder is given an election as to a specific portfolio security he receives. 17 C.F.R. § 270.17a-5 (1969).

No case or release has expressly stated that a sale following the initial "private" sale is essential to finding a distribution. There is authority that the private offering exemption will be denied because of subsequent distribution even though one of the usual elements of sale by the issuer to a statutory underwriter, followed by sales by such underwriter to the public, is missing. A situation in which this result has been urged involves a controlling shareholder who, as a "control person," is deemed to be an issuer under the Act and thus subject to the registration and private offering exemption rules in the distribution of his stock.<sup>48</sup> One authority has taken the position that when a control person donates stock to a charitable institution, the donee may not freely resell the stock publicly without being deemed an underwriter as one "selling for an issuer."<sup>49</sup> The control person, therefore, will have violated the registration requirements of the Act even though he made no sale, and the donee will be an underwriter even though it did not purchase.<sup>50</sup> The result may be the same in the situation of a daughter of the control person who, in order to diversify her portfolio, sells a substantial block of securities she has received from her father as a wedding gift. While the donor receives no tax advantage from the daughter's sale, "the family relationship makes it easier to say that the daughter is an 'underwriter' in the sense that she is 'selling for' her father."<sup>51</sup> In both of these examples, the control person's transfer may violate the registration requirements even though he receives no value himself, at least where his donee had no original investment intent.

It is also clear that one may be an underwriter even though *he* receives no value. The language of Section 2(11) contemplates this, for it defines underwriter as "any person who . . . offers or sells for an issuer. . . ." The classic example is found in *SEC v. Chinese Consolidated Benevolent Association*.<sup>52</sup> There, Consolidated formed a committee to solicit the purchase of bonds issued by the Republic of China. Its selling activities were limited to the Chinese communities in the New York area. It had no contract with the Chinese government and was not compensated for its efforts. Nevertheless, the Court of Appeals for the Second Circuit held that it was an underwriter within the statutory definition of Section 2(11).<sup>53</sup>

Thus it seems that the private offering exemption may be denied even though (1) the issuer does not receive value or (2) the under-

48. A control person is one who possesses, directly or indirectly, "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405(f) (1969). See Sommer, *Who's "In-Control"?* — *S.E.C.*, 21 *BUS. LAW.* 559 (1966), for an excellent discussion of this concept.

49. Letter from Chief Counsel, Division of Corporation Finance to CCH, Aug. 8, 1962, 1 CCH *FED. SEC. L. REP.* ¶ 1551.60 (1967). This is so where the gift is made "under circumstances in which a redistribution to the public by the donee may reasonably be anticipated." *Id.*

50. In connection with gifts by control persons, many lawyers require that the donee take only for investment. IV L. LOSS, *SECURITIES REGULATION* 2647 (Supp. 1969). This, however, diminishes the tax value of the gift in the eyes of the donor. S.E.C. *PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS* 32-33 (C. Israels ed. 1962).

51. IV L. LOSS, *SECURITIES REGULATION* 2577 (Supp. 1969).

52. 120 F.2d 738 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941).

53. *Id.* at 740.

writer does not receive value. But in each of the situations just discussed the public buyers from either the issuer or the underwriter paid value to one or the other. The proponents of the private sale/spin-off technique would argue that this difference is crucial on the ground that the draftsmen of the Act limited the requirement of registration in Section 5 to a public sale and only intended to protect persons who gave value for shares in an initial public offering. Even on this limited interpretation, value may be present. It may be that the requisite value passes in the subsequent sales by the dividend distributee of Pub-Corp to other members of the public.<sup>54</sup> This value theory might require a finding that the distributees themselves were underwriters. Although the history of the Act and the manner of Commission enforcement demonstrate a disinclination to label average shareholders as statutory underwriters, "average shareholders" who receive gifts of small amounts of stock, either by way of dividends from a dormant corporation or otherwise, could readily be deemed to be participating in a distribution for an issuer within the language of Section 2(11) when they accept the gifts with intention to resell.<sup>55</sup>

Although the argument that value must pass from the public may seem at first to fit within the statutory scheme, it is submitted that if the term "distribution" as used in Section 2(11) and read into Section 4 requires a sale, then the finding that a Pub-Corp dividend of Pri-Corp's shares is a sale can be based either on value moving from the Pub-Corp shareholders or on value moving from any source to Pri-Corp.

It has been considered theoretically possible to label the dividend-distributing Pub-Corp an "underwriter" by finding that the requisite value for the dividend transfer has passed to the issuer in the form of the consideration for the original sale.<sup>56</sup> A better value argument based on the real substance of the transaction is that the issuer, Pri-Corp, receives value in the form of benefit from the public holding of the stock. Thus, close to the facts in *SEC v. Chinese Consolidated Benevolent Association*,<sup>57</sup> Pub-Corp is arranging transfer of Pri-Corp's shares to the public, with the benefit or value accruing to Pri-Corp.

Even if these value-passing contentions are inconclusive, it might also be argued that a complete absence of value in a Pri-Corp/Pub-Corp transaction will not prevent finding Pub-Corp to be an underwriter

54. 12 BNA SEC. REG. & L. REP. B-3 (Aug. 20, 1969).

55. Generally, the Commission "has refused to apply the 'underwriter' definition to small purchasers, apparently on the theory that resale of the few shares purchased could not possibly be considered a 'distribution' of — as opposed to a mere trading in — securities." Note, *Regulation of Nonissuer Transactions under Federal and State Securities Registration Laws*, 78 HARV. L. REV. 1635, 1638 (1965).

[D]espite statements that "... the ordinary investor who buys directly from the affiliate is not an 'underwriter' even if he takes for resale," it is suggested that it would be dangerous to rely upon such language if the controlling person were disposing of securities aggregating a substantial amount in a group or series of transactions which might be construed as a "public offering", even though each of the purchasers and each of the offerees could be classified as an ordinary investor and thus apparently immune from the role of "underwriter" even if he resold; it might not be too difficult to discover the presence of an "underwriter." Sommer, *Who's "In-Control"?* — S.E.C., 21 BUS. LAW. 559, 584 (1966).

56. Bromberg, *Corporate Liquidation and Securities Law — Problems in the Distribution of Portfolio Securities*, 3 B.C. IND. & COM. L. REV. 1, 10 (1961).

57. 120 F.2d 738 (2d Cir.), cert. denied, 314 U.S. 618 (1941).

within Section 2(11). Nowhere in the Act is the key word in Section 2(11), "distribution," defined to require "value." Nor does it appear that any court has even considered the question of whether or not value is required. The Act's broader disclosure objectives are equally subverted where no value is immediately given.

The absence of a "sale" in the dividend transfer from Pub-Corp to its stockholders is simply too slick a rationale and based upon a too literal construction of the authorities to avoid the registration requirements of the Act. It flies in the face of the overall purpose of the Act and subverts the very reasons for the private offering exemption.

Admittedly, it requires either a rather complex analysis to find value, or a decision supported only by the policy of the statute that value is not necessary, to conclude that Pub-Corp, in declaring a dividend, is effecting a "distribution" of the securities.<sup>58</sup> Unfortunately, the proposed rules of the SEC, aimed at implementing the recently published Wheat Report relating to disclosure to investors, do not quite reach the distribution problem as it exists in the private sale/spin-off context.<sup>59</sup> The proposed rules would establish some objective tests to determine when purchasers of securities are "underwriters" and when they are not. The concept of an underwriter as one who "offers or sells for an issuer" is declared to include a person who sells a "restricted" security in a "distribution."<sup>60</sup> A "restricted security" is defined as any security acquired from its issuer "in a transaction or chain of transactions none of which was a public offering or other public disposition."<sup>61</sup> A restricted security will cease to be restricted after it has been such for any period of five years during which the issuer had gross revenues of at least \$250,000 in each year.<sup>62</sup> Holders of restricted securities of issuers who file certain required reports, however, can make specified limited sales after holding the securities for one year without such sales being deemed a "distribution" within Section 2(11). With this qualification, "distribution" is defined to mean "any public offering of a security."<sup>63</sup>

As applied to the private sale/spin-off problem it would appear that the proposed rules offer no solution to the problem of whether Pub-Corp is a qualified purchaser within the private offering exemption. The rules do clearly classify the securities received by Pub-Corp from Pri-Corp as "restricted" securities. Moreover, by requiring that the definition of underwriter "shall include (but not be limited to) any person who *disposes* of a restricted security . . . in a distribution"<sup>64</sup> there may be a conscious effort to eliminate the requirement

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58. Those in control of Pub-Corp may well be underwriters when they sell to the public the dividend security they received. *SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959).

59. In its Securities Act Release No. 4997 (Sept. 15, 1969), the Commission slightly modified the rules proposed in the WHEAT REPORT, *supra* note 45. The citation of proposed rules hereafter is to those in Release No. 4997 (Sept. 15, 1969).

60. Proposed Rule 160.

61. Proposed Rule 161(a).

62. Proposed Rule 161(b).

63. Proposed Rule 162.

64. Proposed Rule 160 (emphasis added).

that the underwriter *sell* for value. But this is partially dispelled by defining distribution to mean any "public offering," thereby incorporating the sale requirement attendant to that term. A dividend distribution of a portfolio restricted security may therefore not be a "distribution."

Even if the dividend to Pub-Corp shareholders is not a public offering, the public market in Pri-Corp shares will not be achieved if the recipients of the dividends are not free to resell their shares. From the definition of restricted security and from other provisions of the proposed rules, it would appear that the Pri-Corp shares continue to be restricted securities in the hands of Pub-Corp shareholders.<sup>65</sup> Although the Wheat Report and the proposed rules do provide that relatively small quantities of restricted stock of companies making certain required reports to the SEC can be sold without the sale being deemed a public offering,<sup>66</sup> no quantity rule is suggested as to other companies. Although proposing a quantity rule as to some corporations might suggest that no quantity of restricted securities of other companies can be resold without registration, the explanatory report makes it clear that no such negative implication is intended and that only public offerings require registration.<sup>67</sup> Thus, past practice must be considered, and such practice indicates that it is highly unlikely that the dividend recipients, when selling their few shares, will be labeled "underwriters" as having made a "distribution."<sup>68</sup>

A direct approach to the distribution problem is suggested. The issuer, Pri-Corp, is claiming the private offering exemption on the ground that *it* is not making a sale to the public. In judging whether this claim is correct, it is artificial to focus separately first on the sale to Pub-Corp and then on the subsequent actions of Pub-Corp.<sup>69</sup> Examination of the purchaser's intent in making the purchase, together with his actions after the purchase, is necessary to determine whether the original issuer made a private or public offering. The ultimate question is the character of the issuer's sales; this character is ultimately explained by the character of the purchaser's intent and action. In the private sale/spin-off transaction the very purpose for Pri-Corp's sale is to place the securities in the hands of the public by using Pub-Corp as a conduit. The Commission's most recent release in this area suggests that it may view both transactions together as one scheme by Pri-Corp to distribute its securities publicly and without the protective cloak of the private offering exemption.<sup>70</sup> Distribution has been described as "the entire process by which in the course of a public offering a block of securities is dispersed and

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65. The definition is found in proposed Rule 161(a). See also proposed Rules 161(c) and 162(c)(3).

66. Proposed Rule 162(b)(3)(E).

67. WHEAT REPORT, *supra* note 45, at 189.

68. See note 55 *supra*.

69. SEC v. Mono-Kearsarge Consol. Mining Co., 167 F. Supp. 248, 252 (D. Utah 1958).

70. SEC Securities Act Release No. 4982 (July 2, 1969).

ultimately comes to rest in the hands of the investing public."<sup>71</sup> Under this concept the initial sale and hence the entire scheme may not satisfy the private offering exemption.<sup>72</sup>

### III. THE MERGER AS A VEHICLE FOR GOING PUBLIC AND SEC RULE 133

In the Pri-Corp/Sub-Pub-Corp *Example C* merger situation, the essence of the transaction is, of course, the same as in *Examples A* and *B*, namely the transfer of an interest in Pri-Corp to the shareholders of a publicly held company. The Securities Act of 1933 does not apply if there is no "sale" of securities, and the Securities Exchange Act of 1934 requires registration and proxy disclosure only where the publicly held corporation has total assets exceeding one million dollars.<sup>73</sup> Thus, under present law, the essence of the *Example C* transaction, the indirect transfer of something to the public, cannot be the prime basis for requiring disclosure. The possible weakness in the scheme stems from the fact that a merger does involve the transfer of stock of the surviving corporation to the shareholders of the disappearing corporation. Arguably, since these shareholders give value in the form of either the assets or the shares of the disappearing corporation, Pri-Corp, they take the surviving corporation shares in a sale transaction. If a sale is involved, then registration would be required unless all of the shareholders of Pri-Corp are qualified offerees so that the private offering exemption of Section 4(2) is applicable.

In the early days of the Securities Act of 1933, the Federal Trade Commission, then charged with administration of the Act, declared mergers and consolidations to be subject to the registration requirements of the Act.<sup>74</sup> The FTC conclusion was short-lived.<sup>75</sup> On September 19, 1935, the Securities and Exchange Commission, which had by then taken over the administration of the Act, indicated in a note to its amended Form E-1 that it deemed:

. . . no sales to stockholders of a corporation to be involved when pursuant to statutory provisions or provisions contained in the Certification of Incorporation, there is submitted to a vote of such other person a plan or agreement of a statutory merger or consolidation, provided the vote of a required favorable majority would operate to authorize the transaction and bind all stockholders with the exception of dissenting shareholders' appraisal rights.<sup>76</sup>

71. *In re Oklahoma-Texas Trust*, 2 S.E.C. 764, 769 (1937), *aff'd*, 100 F.2d 888 (10th Cir. 1939). See also *In re Lewisohn Copper Corp.*, 38 S.E.C. 226, 234 (1958); *In re Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147, 160 (1935).

72. See 12 BNA Sec. REG. & L. REP. B-1 (Aug. 20, 1969).

73. See §§ 12(g) and 14(a) of the Securities Act of 1934, 15 U.S.C. §§ 78(1)(g) and (n)(a) (1964).

74. Sargent, *A Review of the "No-Sale" Theory of Rule 133*, 13 BUS. LAW. 78, 79 (1957). This interpretation found its basis in the legislative history of the Act. WHEAT REPORT, *supra* note 45, at 254-55.

75. An early SEC decision determined that a proposed statutory consolidation between Merck Corporation and Merck & Company, Inc., did not involve a "sale" of shares; therefore no registration was required. WHEAT REPORT, *supra* note 45, at 255-56.

76. SEC Securities Act Release No. 493 (Sept. 20, 1935).



Although Form E-1 was abolished in 1947,<sup>77</sup> the Commission continued to adhere to the policy of excluding transfers of shares incident to corporate acquisition transactions from the scope of the registration provisions of Section 5.<sup>78</sup> In a release dated August 2, 1951,<sup>79</sup> the Commission formalized the administrative interpretation based upon former Form E-1 in its Rule 133.<sup>80</sup> This rule, conceived in controversy and rarely left unchallenged since its birth, again made it clear that the submission and consummation of mergers and similar transactions were deemed not to involve an offer or sale within the meaning of Section 5 of the Act and therefore were not subject to the registration requirements.<sup>81</sup> As this article is written (February 1970), Rule 133 still provides a no sale-no registration cloak of protection for mergers. It further provides, however, as a result of several 1959 amendments,<sup>82</sup> for certain restrictions on the transferability of securities received by "control" persons of a predecessor disappearing corporation as part of a merger plan. If such control persons take a surviving corporation's securities with a view to their distribution to the public, then they shall be deemed to be statutory underwriters within the meaning of Section 2(11) of the Act.<sup>83</sup> In effect, such securities received by them, except for limited amounts,<sup>84</sup> cannot be sold without registration. Of course, since the shareholders of the disappearing Pri-Corp typically would not have a present intention to sell to the public, these 1959 amendments do not substantially limit the *Example C* technique.

Despite the advent of Rule 133, an atmosphere of SEC peace and quiet did not pervade the world of mergers and acquisitions. Six years after the adoption of Rule 133, the Chairman of the Securities and Exchange Commission expressed doubts about its utility: "It has been extremely disturbing for the Commission to encounter indications of . . . evasions of the registration requirements (section 5) of the Securities Act through reliance upon claimed exemptions or statutory constructions where the facts do not meet the statutory tests or the clear statutory intent."<sup>85</sup> The Commission had become "concerned about the use of this Rule as a device to turn loose in the securities markets substantial amounts of securities without registration or use

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77. SEC Securities Act Release No. 3211 (April 14, 1947).

78. Sargent, *A Review of the "No-Sale" Theory of Rule 133*, 13 BUS. LAW. 78, 80 (1957).

79. SEC Securities Act Release No. 3420 (Aug. 2, 1951). This release was later amended to conform the rule to certain provisions of the new Internal Revenue Code of 1954. SEC Securities Act Release No. 3522 (Oct. 26, 1954).

80. 17 C.F.R. § 230.133 (1969). *But cf. In re E.I. duPont deNemours & Co.*, 34 S.E.C. 531 (1953); *In re Talley Industries, Inc.*, Investment Co. Act Release No. 5953 (Jan. 9, 1970), for the rule under Section 17(a) of the Investment Co. Act of 1940, and *Dasho v. The Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), for the rule under Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934.

81. Cohen, *Rule 133 of the Securities and Exchange Commission*, 14 RECORD OF N.Y.C.B.A. 162, 165-66 (1959).

82. SEC Securities Act Release No. 4115 (July 16, 1959).

83. Subparagraph (b) of Rule 133. 17 C.F.R. § 230.133(b) (1969).

84. *See* subparagraphs (d) and (e) of Rule 133. 17 C.F.R. §§ 230.133(d), (e) (1969).

85. SEC Securities Act Release No. 3762 (Mar. 15, 1957).

of a statutory prospectus."<sup>86</sup> In effect, it was feared that innocent shareholders in corporations party to a merger, although not acquiring securities in typical purchase transactions, were being exposed to possible fraudulent schemes and being made to give up something of value in a merger situation without having the magnifying glass of the disclosure requirements of the Act focused on what they were receiving therein.<sup>87</sup>

Although the concern expressed by the SEC at this time was not directed at the back-door-going-public nature of the Pri-Corp/Sub-Pub-Corp merger of *Example C*, just such a merger could be consummated without Commission regulation by virtue of Rule 133. Hence, Pri-Corp, through the shell of Sub-Pub-Corp, could in effect become a public company without being put through the rigorous disclosure paces of registration. Although Sub-Pub-Corp's pre-merger shareholders might have had apparently little or nothing to lose in the merger (perhaps the reason for lack of expressed SEC concern about the transaction), the fact still existed that, subsequent to the merger, trading would occur in Sub-Pub-Corp (in effect Pri-Corp's operations under a new name) stock despite the absence of any information being available through the SEC on the operations of Pri-Corp and the lack of any previous public disclosure of Pri-Corp's operating history. Despite this lack of disclosure, the probability that Pri-Corp management will have involved itself in a sale of securities is at first blush non-existent in the Rule 133 merger situation.<sup>88</sup>

Despite the optimism that such management may muster from the language of Rule 133, the statutory merger between Sub-Pub-Corp and Pri-Corp may not be free of registration under SEC practice at this time, and may soon be subject to more clearly applicable disclosure obstacles by virtue of recent proposals by the SEC for reform of Rule 133.<sup>89</sup> Not long after the adoption of Rule 133, the SEC, in *In re Great Sweet Grass Oils Ltd.*,<sup>90</sup> interpreted Rule 133 as excluding what may be termed "negotiated transactions." This illusive concept was introduced by the following language of the Commission:

The theory of Rule 133 is that no sale to stockholders is involved where the vote of stockholders as a group authorize a corporate act such as a transfer of assets for stock of another corporation, a merger or a consolidation because there is not present the element of individual consent ordinarily required for a "sale" in the ordinary contractual sense . . . . In any event, where the persons negotiating an exchange, merger or similar

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86. Sommer, *Mergers, Consolidations, Sales of Assets — Rule 133*, 16 W. RES. L. REV. 11, 16 (1964).

87. SEC Securities Act Release No. 4115 (July 16, 1957).

88. Even if shareholders of Sub-Pub-Corp had dissenting shareholder fair appraisal rights under applicable corporate law, there would have been few practical problems for the merger in this regard because of the fact that Sub-Pub-Corp had been a shell company with little or no worth. Hence, Pri-Corp would not be subject to significant fair appraisal liability.

89. WHEAT REPORT, *supra* note 45, app. VII-4 (1969); SEC Securities Act Release No. 5012 (Oct. 9, 1969).

90. 37 S.E.C. 683 (1957), *aff'd per curiam*, 256 F.2d 893 (D.C. Cir. 1958).

transaction have sufficient control of the voting stock to make a vote of stockholders a mere formality, Rule 133 does not apply. In such case the transaction is not corporate action in a real sense, but rather is action reflecting the consent of the persons in control, and consequently results in a "sale" as to them.<sup>91</sup>

Since in the typical *Example C* type situation the required majority of shareholders will usually have participated in the preliminary agreements, it is clear that the negotiated transaction concept could pose a substantial threat to the merger device for avoiding registration where the private offering exemption is not available.

There is no good authority, however, as to when the negotiated transaction principle will be applied. At one time it was suggested that the rule had been abrogated.<sup>92</sup> By 1967, however, it became apparent that the principle at least still lurked in the minds of the Commission staff, as so-called *no action* letters were not, as a matter of policy, procurable in merger circumstances indicating "negotiated transactions."<sup>93</sup> Hence, the SEC staff-conceived qualifications still may have to be viewed as a possible, although not intransigently absolute, obstacle in the path of Pri-Corp's goals when following the procedure described in *Example C*.

In addition to the "negotiated transactions" limitation, the *Great Sweet Grass Oils* opinion stated that certain transactions which were apparently under Rule 133, "but which in truth were conducted pursuant to" a pre-existing plan for distributing a substantial amount of securities to the public, are outside the Rule.<sup>94</sup> The 1959 amendments to Rule 133 were an attempt by the SEC to curb some of these "planned distribution" abuses which had emerged in purported Rule 133 transactions. As stated earlier, these amendments imposed limitations on sales of surviving corporation stock received by control persons of the disappearing predecessor corporation. They did not, however, eliminate the "no sale" interpretation which lifted mergers from the clutches of Section 5 registration requirements.

The thrust of the SEC attack on planned distribution transactions has been on merger situations embodying distributions to the public of the issuer's stock when the distributions involve a relinquishment of something of value by the public for such stock. In those instances, the SEC has sanctioned the merger itself by declaring only that a Section 4(1) exemption would not be available to sale transactions by individuals subsequent to the merger since an underwriting within the meaning of the statute would be involved.<sup>95</sup> Thus under current SEC practice the Commission will begin to take aim on merger efforts to go public through the back door only once a distribution has occurred

91. *Id.* at 690-91.

92. Sommer, *Mergers, Consolidations, Sales of Assets — Rule 133*, SELECTED ARTICLES ON FEDERAL SECURITIES LAW 288, 289 (1968). This article originally appeared in 16 W. RES. L. REV. 11 (1964), but was updated by the author for the ABA publication cited.

93. *Id.* at 290.

94. *In re Great Sweet Grass Oils Ltd.*, 37 S.E.C. 683, 690 (1957), *aff'd per curiam*, 256 F.2d 893 (D.C. Cir. 1958).

95. *In re Great Sweet Grass Oils Ltd.*, 37 S.E.C. 683, 690 (1957).

subsequent to a merger transaction which evidences a plan to make public sales of unregistered stock by disappearing-corporation shareholders as an intended step of the merger planners. So in contrast to the spin-off attempts to go public discussed in *Examples A* and *B*, in the case of merger transactions such as *Example C*, present day Rule 133 and planned distribution concepts permit at least the first step toward getting Pri-Corp stock into the hands of public shareholders to be accomplished without SEC action or sanction.

The back entrance to public status which has been opened for private corporations by merger techniques may be partly shut very soon, however, by virtue of recent proposals for reform of Rule 133 suggested in the SEC Wheat Report.<sup>96</sup> The reform has been proposed, not so much out of concern with the problem of going public through the back door via merger techniques, but out of concern for public shareholders in corporations which merge with other corporations, when, with regard to such other corporations, insufficient disclosure information is available for informed shareholder action.<sup>97</sup> This new proposal would, in effect, apply the negotiated transactions approach of finding a sale in all mergers, with registration being required if the transaction is otherwise a public offering. The SEC has proposed that Rule 133 be revised to "provide that the submission to stockholders of a proposal of the kind referred to above [including mergers] is deemed to involve an offering of securities to the security holders of the company being merged or consolidated . . ."<sup>98</sup> As the Commission explains, the reason for the proposed change is that ". . . when such matters are submitted to the vote of shareholders, each such shareholder is being asked to determine whether or not he wishes to surrender the security he then holds for a new security. In practical effect, therefore, the new security is being offered to him."<sup>99</sup> Again, it should be emphasized that the motivation of the Commission behind its proposed Rule 133 revisions does not arise out of concern with the effects of the going public device utilized in the Pri-Corp/Sub-Pub-Corp transaction of *Example C*. Nevertheless, the elimination of the no sale portion of Rule 133 should stifle somewhat the use of *Example C* type transactions to attain public status by virtue of the renewed applicability of the registration requirements of the Act to some of such transactions whether or not previously covered by the SEC proxy rules. In such transactions, therefore, information with regard to Pri-Corp's operation in its new Sub-Pub-Corp form would have to be presented to the Commission for review and would be available to the public trading in Sub-Pub-Corp shares subsequent to the merger.

The offer-sale registration approach to mergers required by proposed Rule 133 may not be applicable to all merger transactions. In fact, it may not be applicable to as many mergers as would a strict

96. See WHEAT REPORT, *supra* note 45, at 280-97 & app. VII-4 (1969).

97. *Id.* This concern relates especially to merger transactions currently not subject to the requirements of SEC proxy regulation.

98. SEC Securities Act Release No. 5012 (Oct. 9, 1969). The release is in accord with proposals in the WHEAT REPORT, *supra* note 45.

99. SEC Securities Act Release No. 5012 (Oct. 9, 1969).

application of the negotiated transaction rule because offerings to less than twenty-five persons are never to be considered public offerings. As part of the amendment of Rule 133, the SEC proposes a Rule 181, which would define the phrase "transactions not involving any public offering" to include the offer or sale of securities to not more than twenty-five persons who are shareholders in a business being acquired in a merger or other corporate combination transaction.<sup>100</sup> Such transactions would, of course, still be subject to the traditional planned distribution rule. Thus the Commission states that a public offering requiring merger registration might be involved in an otherwise exempt Rule 181 transaction where one or more of the group of twenty-five make a reoffering of the securities to the public.<sup>101</sup>

If proposed Rule 133 covers the Pri-Corp/Sub-Pub-Corp *Example C* situation, the SEC proposals with regard to Rule 133 and registration of mergers will have a significant deterrent effect on attempts to use merger devices between private corporations and public shell corporations as a means for going public through the back door. Under the proposed Wheat Report procedure if Pri-Corp has more than twenty-five shareholders it probably would have to divulge information about its operations as a part of the merger. Therefore, not only will significant information be received by the post merger Sub-Pub-Corp shareholders, but also, at least at the inception of Pri-Corp's so-called public existence, there will be registration information on file at the SEC so as to give individuals who later trade in the post merger Sub-Pub-Corp shares some kind of disclosure protection with regard to their investment decisions. If the SEC's proposals with regard to reforming Rule 133 are not adopted, merger transactions as a device for achieving public status for corporations such as Pri-Corp will be subject only to the ad hoc deterrent and sanction that may exist by virtue of the SEC planned distribution and negotiated transaction doctrines.

It is unfortunate that the expanded private offering exemption of proposed Rule 181 is part of the proposal to amend Rule 133 because many mergers designed to create a public market in Pri-Corp stock will escape the rule through the exemption. However, a statutory change would probably be needed to prevent most of such uses of this exemption. In terms of the problem which the proposed amendments to Rule 133 are designed to meet — the need of unsophisticated shareholders of a corporation disappearing in a merger for accurate information as to the corporations involved — the private offering exemption, and perhaps the expanded private offering exemption, may be appropriate. As stated at the beginning of this section, the substantive problem in the case of going public without registration via a merger is the indirect transfer of something to the shareholders of the surviving corporation.

To meet this problem directly, the registration or proxy solicitation requirements in the Securities Exchange Act of 1934 should be expanded to require proxy disclosure in all cases where a publicly held corporate shell such as Sub-Pub-Corp proposes a merger with a

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100. *Id.*

101. *Id.*

corporation for which some form of disclosure has not been filed with the SEC.<sup>102</sup> In addition, to avoid the disclosure problems involved in the *subsequent* trading of shares of corporations like Sub-Pub-Corp which have taken over the operations of a private company by way of merger, the requirement for the delivery of proxy statements or prospectuses should be imposed on brokers dealing with such shares.

#### IV. NON-REGISTRATION DISCLOSURE AND BROKER-DEALER PROBLEMS

Avoidance of the registration requirements of the Securities Act of 1933 has been the major concern of critics of the techniques used in going public through the back door.<sup>103</sup> Non-compliance with the anti-fraud provisions, in particular Section 10(b)<sup>104</sup> and Rule 10-b-5<sup>105</sup> promulgated thereunder, of the Securities Exchange Act of 1934 also pose serious though less sharply defined problems for Pri-Corp management contemplating a step towards public status via one of the devices described in *Examples A, B, and C*.

Presumably Pri-Corp, in all of the examples, was faced with neither the necessity nor the responsibility of disclosing information concerning its operations during the days of its purely private company existence. And because its stock went public without registration and its concomitant disclosures, Pri-Corp operating information, including financial data, still remains beyond the reaches of the securities marketplace. Hence, when trading begins in the securities of Pri-Corp, after it has achieved public status through any of the introductory examples, it is unlikely that sufficient information will exist with regard to such securities to allow for informed investment decision.

Rumors based upon distortions of the status of Pri-Corp's operations may stimulate a purchase of Pri-Corp shares in the over-the-counter market. Also, the original holders of such shares may sell their Pri-Corp securities without having made an informed investment decision because of the lack of sufficient Pri-Corp disclosure. Although the thread of liability may be somewhat tenuous because of the missing strand of privity,<sup>106</sup> if Pri-Corp management can be linked to a plan which contemplated public trading of such securities, then such management may find that its back door to public status has opened into a den of Rule 10-b-5 or other securities anti-fraud legal entanglements. Arguably, Pri-Corp management played a significant role in dumping Pri-Corp securities into the public marketplace. By virtue of such an act, coupled with the lack of information available

102. See 15 U.S.C. §§ 78(1) and (n) (1964) for the present law.

103. SEC Securities Act Release No. 4982 (July 2, 1969); Wall Street Journal, July 3, 1969, at 6, cols. 2, 3; Taylor, *The Shell Game — How Some Utah People Used Dormant Concern To Make Easy Money*, Wall Street Journal, Aug. 15, 1969, at 1, col. 6.

104. 15 U.S.C. § 78j(b) (1964).

105. 17 C.F.R. § 240.10b-5 (1969).

106. As in other areas of contract law, however, privity has "all but disappeared from 10b-5 proceedings." A. BROMBERG, *SECURITIES LAW: FRAUD — SEC RULE 10b-5* § 8.5, at 205 (1969). See Weisen, *Disclosure of Inside Information — Materiality and Texas Gulf Sulphur*, 28 Md. L. Rev. 189 (1968).

about Pri-Corp before or after it had gone public, Pri-Corp management, among others, might be deemed to be a part of a manipulative or deceptive scheme perpetrated upon the public and therefore might be subject at the least to SEC, if not private shareholder, action.<sup>107</sup>

In addition, the Commission has recently suspended trading in the securities of several over-the-counter companies created by means of the public shell/spin-off device of *Example B*.<sup>108</sup> This is another potential weapon in the anti-fraud arsenal which private corporate management should contemplate before going public through the back door.

This disclosure discussion is not intended to cover the clearly unscrupulous use of shell companies and back door public offerings. As to unethical promoters of shell companies who inflate stock prices with misleading corporate information and then make sales of their own shares at allegedly fraudulent inflated prices,<sup>109</sup> the SEC has already instituted anti-fraud actions based upon Sections 17(a) and 10(b) of the Securities and Exchange Act.<sup>110</sup> Although the mass produced spin-off of *Example B* may lend itself to such deceptions, it is to be presumed throughout this discussion that Pri-Corp management has not involved itself in anything so overtly fraudulent.<sup>111</sup> Rather than contemplating quick sales of its own personal shares at artificially inflated values, such management merely used a back door technique to reach public status without the traditional "going-public" problems. Fraudulent sales of its own shares may take place later in time, but presumably, unlike unscrupulous "shell game" promoters, such sales were not a part of the Pri-Corp management's plans for its back door public offering.

Any discussion of non-registration disclosure problems as they relate to back door public offerings cannot be closed without mention of the problems of broker-dealers. Broker-dealers necessarily will be involved in transactions in Pri-Corp stock that has achieved public status. The broker-dealer is subject to severe sanctions if he is involved in a transaction which involves a deception or lack of disclosure. A broker-dealer suggesting a Pri-Corp security to a customer in the absence of adequate information concerning Pri-Corp may find itself tangled in a web of anti-fraud problems. Furthermore, such dealer "is under an obligation to make his customer aware of known adverse factors and to direct the customer's attention, if such be the case, to the lack of available information necessary to reach an in-

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107. A manipulative or deceptive scheme would violate subsection (1) (scheme to defraud) of Rule 10b-5, thereby giving rise to SEC investigation and disclosure, A. BROMBERG, *SECURITIES LAW: FRAUD — SEC RULE 10b-5* § 10.1, at 234 (1969), followed by private action for rescission or damages. *Id.* § 9.1, at 226.

108. 21 BNA SEC. REG. & L. REP. A-4, A-5 (Oct. 22, 1969); Wall Street Journal, Dec. 23, 1969, at 4, cols. 1, 2; Wall Street Journal, Dec. 10, 1969, at 2, cols. 3, 4; Wall Street Journal, Dec. 5, 1969, at 17, col. 1.

109. Taylor, *The Shell Game — How Some Utah People Used Dormant Concern to Make Easy Money*, Wall Street Journal, Aug. 15, 1969, at 1, col. 6.

110. See Remarks of Homer H. Budge, Chairman, SEC, at National Security Traders Assoc., Boca Raton, Fla., Oct. 19, 1969. (Homer H. Budge also offered a description of the machinations of such transactions.)

111. Naturally, however, the legal analysis applicable to the examples described in this article will relate to the unscrupulous shell game players as well as our misguided but, nevertheless, scrupulous hypothetical private management.

formed judgment as to the value of the securities being offered or sold to the customer."<sup>112</sup> On the other side of the usual public market transaction, when a broker-dealer receives an order "to sell securities of a little-known, inactive issuer, or one with respect to which there is no current information available, except possible unfounded rumors,"<sup>113</sup> he must have obtained adequate information about the issuer and the person or persons desirous of effectuating a trade in order to be reasonably certain that he can comply with the disclosure requirements imposed upon him by the anti-fraud provisions of the Securities and Exchange Act of 1934.<sup>114</sup>

Despite the lack of a direct contractual relationship or privity between the broker-dealer and the issuer or a control person of the issuer, the dealer must make a reasonable inquiry about the transaction in order to avoid being charged with participation in an illegal distribution.<sup>115</sup> It is difficult to comprehend how a broker-dealer, contemplating compliance with a request to trade Pri-Corp stock, upon inquiry into the nature of such stock, could make any kind of recommendation to a prospective purchaser in view of the obviously inadequate disclosure about Pri-Corp at the time of the proposed trade. Or as the Commission chairman recently more eloquently stated:

When trading develops in the stock of corporations for which there is not both accurate and adequate information, the duty falls upon you [broker-dealer] to recognize the situation and instigate an investigation through your firm before you continue trading. Your failure in this area may well result in financial loss to the public and it goes without saying that it also may well result in your receiving official greetings from the S.E.C.<sup>116</sup>

## V. CONCLUSION

New concepts of "going public" have crept into the minds of owners of private companies who are intent on putting their firms in the pink sheets of the over-the-counter market. These concepts involve the use of spin-off and shell acquisition techniques which avoid traditional avenues of going public, such as underwriter involvement and compliance with SEC registration requirements. A private-sale/spin-off transaction or a shell merger transaction may enable companies like Pri-Corp to go public to the extent that its shares or the shares of its successor will be in the hands of a large number of public shareholders.

Public status for the company may bring joy to the hearts of the Pri-Corp management, but such elation may be ephemeral when the ramifications of the shell acquisition or spin-off technique become fully evident. Private corporate management which has employed such de-

112. 12 BNA SEC. REG. & L. REP. B-3 (Aug. 20, 1969).

113. *Id.*

114. *Id.* at B-4.

115. *Id.*, citing SEC v. North American Research & Dev. Corp., 280 F. Supp. 106 (S.D.N.Y. 1968) and SEC v. Mono-Kearsarge Consol. Mining Co., 167 F. Supp. 248 (D. Utah 1958).

116. Remarks of Homer H. Budge, SEC, at National Security Traders Assoc., Boca Raton, Fla., Oct. 19, 1969.



vices may find that it has involved itself and its company in violations of the registration requirements of the Securities Act of 1933. Such violations may exist by virtue of the fact that no exemption from registration may be claimed for the private sale aspect of the private sale/spin-off technique described in *Examples A* and *B*. Or violations may arise, in the case of merger transactions like *Example C*, because of the non-existence of Rule 133 "no sale" treatment for such a merger in light of the SEC's application of "planned distribution" qualifications to such rule. Also, the use of these techniques may ultimately result in anti-fraud problems under the Securities and Exchange Act of 1934. A distinct lack of operating and financial information about corporations like Pri-Corp may raise substantial disclosure problems for shareholders attempting to sell shares of Pri-Corp once it has achieved its new public form. Moreover, broker-dealers may find themselves unable to be involved in trades of such shares without sanction because of this lack of information.

In addition, Pri-Corp management may ask, whether or not it finds itself involved in securities law violations, whether the company has really benefited in becoming public by means of spin-off or shell acquisition devices. The company has not, in fact, raised any funds to invest in its operations as would be the case in a normal public offering of its shares. Moreover, the fact that it has spread its shares without a planned financing program may be deleterious to its future abilities to obtain financing through the sale of securities. The reluctance of brokers to handle the shares, or the warnings they give potential buyers, may mean a public market only at a very low price. The management of Pri-Corp may therefore come to realize that it should have waited for its company to develop further and to mature sufficiently so that it might have achieved public status through a conventional public offering financing program rather than to have reached such status by merely having gone public for the sake of going public.

Hence, companies like Pri-Corp may find themselves involved in possible SEC legal problems by putting the stock of their concerns into public hands by other than the traditional means of going public. Furthermore, they may also find that they have achieved very little from a practical point of view by moving into the realm of public companies through a back door.