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THE SECURITIES ACT OF 1933 AND STOCKHOLDERS OF ACQUIRED CORPORATIONS

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WHEN corporation X proposes to acquire corporation Y in a form of tax-free reorganization, it is safe to assume that the tax implications of the transaction have been considered thoroughly, particularly as they affect stockholders of the corporation to be acquired. The securities ramifications of the transaction generally receive more superficial consideration, however, even though the choice of the form of reorganization can profoundly affect stockholders of the acquired corporation. This article will examine the status under the Securities Act of 1933[1] (Securities Act) of the stockholder of a corporation the control or assets of which are acquired in a tax-free reorganization. From the standpoint of the tax laws, the common methods of acquiring corporate control are the *"A,"* the *"B,"* and the *"C"* reorganizations; that is to say, the statutory merger, the exchange of stock, and the acquisition of assets for stock, sometimes termed a quasi-merger or practical merger.[2] *"D," "E,"* and *"F"* reorganizations, which involve spin-offs, recapitalizations and reincorporations, also are affected by the securities laws. However, since these reorganizations involve changes in the form or capital structure of a single corporate entity rather than the acquisition of one business by another, they are beyond the scope of this article.

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[1] 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1958), as amended, 15 U.S.C. §§ 77b-h (Supp. V, 1964).

[2] The designations *"A," "B,"* and *"C"* represent terminology derived from the tax laws, not the securities laws. See INT. REV. CODE OF 1954, § 368 (a) (1). Moreover, as will be seen below, certain of these reorganizations may be exempted from registration under the Securities Act, even though for certain technical reasons they may not comply with the tax-free reorganization requirements of the Internal Revenue Code.

THE "B" REORGANIZATION

A *"B"* reorganization is tax free both to the participating corporations and to the stockholders of the acquired corporation if the acquiring corporation, in exchange *solely* for shares of its own voting stock, or for shares of voting stock of a corporation which controls the acquiring corporation, acquires from the stockholders of the acquired corporation at least eighty percent of the outstanding shares of voting stock of the acquired corporation and eighty percent of the shares of all other classes.[3] The acquiring corporation obtains several advantages from employing this method—the business to be acquired is received as a unit; its contingent liabilities, if any, are insulated from the parent; and the corporate procedures involved are far less complicated than those required under a merger or asset acquisition.

From the standpoint of the securities laws, however, the acquiring corporation is in precisely the same situation as if it were offering shares of its capital stock to the stockholders of the acquired corporation for cash. Consequently, in the absence of an exemption, this offering must be registered under the Securities Act. If the number of stockholders of the acquired corporation is relatively small, it may be possible for the acquiring corporation to rely upon the so-called private placement exemption, assuming, of course, that the stockholders are willing to take their stock for investment purposes. For its own protection the acquiring corporation will probably wish to police this investment representation. This is commonly accomplished by placing an investment stop in the files of the transfer agent, by causing the certificates themselves to be stamped with a legend indicating that they were issued in reliance upon the exemption contained in section 4 (2) of the Securities Act, and by requiring the stockholders of the acquired corporation to agree contractually that prior to the expiration of a specified period of time, say two years, the company and the transfer agent be furnished with an opinion of reputable counsel regarding any proposed trans-

[3] INT. REV. CODE OF 1954, §§ 368 (a) (1) (B), (c). The latter 80% requirement has been interpreted to mean 80% of the shares of *each* of such other classes, not merely 80% of the total number of non-voting shares. Rev. Rul. 259, 1959-2 CUM. BULL. 115. Under the Revenue Act of 1964, 78 Stat. 19 (1964), voting shares of a corporation controlling the acquiring corporation may be given in exchange for stock of the acquired corporation. Revenue Act of 1964, § 218, 78 Stat. 57 (1964). This change conforms to the scheme of the *"C"* reorganization.

fer to the effect that such transfer will not violate the original investment intent expressed by the stockholder.[4]

The holding period of two years mentioned above is somewhat arbitrary. As may be imagined, there has been much speculation as to what constitutes a safe "holding period" in order to demonstrate that the purchaser of securities in a private placement had the requisite "investment intent."[5] The Securities and Exchange Commission (Commission) has never conceded that the passage of any minimum "holding period" will ever guarantee or conclusively demonstrate investment intent, but rather has stated that original investment intent will be determined by all the "facts and circumstances" surrounding the original acquisition and a proposed disposition.[6] Indeed, acquiring with the intention of holding for a specified period of time and then disposing of the securities is not purchasing with an investment intent at all. From a practical standpoint, however, certain guidelines have been established for purposes of determining when securities originally taken for investment may be disposed of safely. Thus the phrase "holding period" has become firmly established in the argot of securities lawyers, and the concept embodied thereby has become as important as is the capital gains holding period to a tax lawyer. During the early years of the Securities Act, it was generally assumed that a holding period of one year would be sufficient to demonstrate investment intent.[7] The thirteen-month period was a frequently used talisman.[8] More recently, a period of two years has come to be accepted as a rule of thumb; this is the period of time during which the Commission has required that an S-14 registration statement be supplemented.[9]

It may be that the stockholders of the acquired corporation will not be willing to accept stock of the acquiring corporation subject

[4] Contracts with stockholders of the acquired corporation must be carefully worded so as to indicate that their purpose is merely to assist in policing, and that there is no implication that the stockholders are taking with the intention of selling upon expiration of the specified period. See SEC Securities Act Release No. 4552, Nov. 6, 1962.

[5] See Garrett, *Federal Securities Act—An Introduction to Jurisdiction,* 5 CORP. PRAC. COMM. 16, 36-46 (1963).

[6] SEC Securities Act Release No. 4552, Nov. 6, 1962.

[7] See SEC Securities Act Release No. 285, Jan. 24, 1935. (Opinion of General Counsel.)

[8] While this period had no statutory basis as such, it was derived from the old thirteen-month prospectus period, that is, the period (prior to the 1954 amendments) after which a prospectus became stale.

[9] See text accompanying note 37 *infra.*

to investment restrictions. Although they may have no present desire to dispose of the shares of the acquiring corporation within the immediate future, by the same token they may be unwilling to represent that they are taking the stock for investment purposes. They may insist upon "fully registered" stock, meaning stock which will be disposable by them at any time. This will leave them free to make immediate sales whenever disposition is dictated by general market conditions or personal circumstances.

Unfortunately, this course of action is not easily implemented. First, contrary to a prevalent misconception among laymen and even some segments of the legal profession, it is not possible to register stock in the abstract. Registration can only be accomplished in connection with a presently contemplated bona fide public offering of stock; with certain exceptions, there can be no registration of securities for the "shelf." Even if an acquiring corporation went through the effort of registering stock offered to a small number of stockholders of a closely-held acquired corporation, such stockholders would not receive freely disposable stock. The Commission would not regard such an offering as a bona fide public distribution of securities.[10] Thus, even though he might receive registered stock, each stockholder would be considered a statutory underwriter and would be required to deliver a current prospectus to each person purchasing from him in a snbsequent resale, regardless of the amount of time having elapsed since his acquisition of the stock.

In order for the stockholders of a closely-held acqnired corporation to receive shares which are freely alienable, a bona fide secondary distribution of the shares by the stockholders would have to be effected immediately following the exchange offering. Such a distribution could take either of two forms. It might consist of a fully syndicated offering by an underwriting group at a set price, thereby effecting the requisite public distribution. In the alternative, if the stockholders are willing to commit themselves to a disposition of the shares over an extended period of time, the proposed method of offering could consist of a series of sales on an exchange or in the

[10] A similar problem is presented when substantial purchasers in a "private" transaction wish fully registered stock, and the issuer is willing to comply.

In these instances there is a curious reversal of contentions. Counsel for the issuer would argue that the issue is a public offering, since the purchasers are unwilling to take for investment. The Commission, on the other hand, would argue that the offering is private, or at least nonpublic, even though the purchasers may be statutory underwriters if they resell!

over-the-counter market, through the medium of broker-dealers, upon the basis of a formula price described in the prospectus. The latter method not only exposes the stockholders to the risks of a declining market, but is subject to legal intricacies under the securities laws, particularly the anti-manipulation provisions of the Securities Exchange Act of 1934[11] (Exchange Act). The dangers of a haphazard, sporadic distribution of shares by a number of stockholders were adverted to in the *Hazel Bishop* decision,[12] wherein the Commission stop-ordered a registration statement pursuant to which such distributions were being made. After discussing a number of misrepresentations comprising the basis of the stop order, the Commission went on to observe that during a prolonged distribution there was the possibility, and even the probability, of illegal market manipulation, however inadvertent, by or on behalf of selling stockholders and brokers effecting the distribution. Moreover, if bids for, or purchases of, a security of the same class were being made by or on behalf of any selling stockholder, or by the issuer or any dealer or broker participating in any of such sales, there would have been a violation of rule 10 (b) (6) under the Exchange Act.

The Commission has since evolved requirements for such offerings designed to avoid such violations. The selling stockholders must advise broker-dealers selected to execute their sale orders that such broker-dealers must not have made solicited purchases of the stock for a period of ten business days prior to the time of acceptance of the sell order; otherwise such broker cannot handle the order. The broker itself must acknowledge that it has not engaged in any purchases of the stock during the proscribed period. Moreover, letters and other written material in aid of such an offering must be preceded by a statutory prospectus, and compliance with rule 153 of the Securities Act (under which prospectuses are made available at the trading post on the exchange) will not fulfill this requirement. These factors indicate that the syndicated offering is the most desirable method of secondary distribution, despite the fact that underwriting commissions will normally exceed brokerage commissions.

The choice[13] of the stockholder regarding the method to be

[11] 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a to hh-1 (1958), as amended, 15 U.S.C. §§ 78c-s (Supp. V, 1964).

[12] Hazel Bishop, Inc., 40 S.E.C. 718 (1961).

[13] The discussion in this paragraph is relevant only where the value of the stock received exceeds the tax basis of the shares of the acquired corporation. Where a

utilized in effecting a secondary distribution is further complicated by the policy of the Internal Revenue Service that the disposition of over fifty percent of the stock received in an otherwise tax-free *"B"* reorganization will nullify the tax-free character of the reorganization. In such a case the Service will view the reorganization as failing to meet the test of business continuity. This test is apparently applied to the holdings of all stockholders participating in the exchange, so that the actions of other stockholders may deprive a particular stockholder of tax-free treatment even though he retains over fifty percent of the stock which he receives. While subsequent unrelated sales of the acquiring corporation's stock, even in excess of fifty percent, might not result in retroactive disqualification, it could hardly be argued that the filing of a substantially concurrent registration statement by the acquiring corporation did not constitute a pre-arranged plan of disposition. If the stockholder decides to register all the stock in a syndicated offering, which is promptly distributed, there is no problem, since the stockholder will have the money with which to pay the tax. On the other hand, if he elects to dispose of over fifty percent of the stock in a series of brokerage transactions at the market, it is conceivable that he might have to pay the tax before receiving the proceeds of the sales, or that the value of the stock when sold may be less than its value on the date of the exchange, the latter being determinative for tax purposes.

A further tax problem arising in connection with a *"B"* reorganization and the registration of stock received pursuant thereto is the requirement that the stockholder receive *solely* voting stock of the acquiring corporation or a corporation in control of the acquiring corporation. Any other consideration is regarded as "boot," which invalidates the entire tax-free character of the exchange.[14] "Boot" is not confined to cash, and may take the form of any other thing of value, such as property or promises to pay additional consideration in the future. Is an agreement by the acquiring corporation to register the stock, whether immediately upon consummation of the transaction or at some time in the future at the request of the stockholder, considered "boot"? The better view is that it would not be so considered. Suppose, however, that coupled with an agree-

loss is involved, the stockholder will ordinarily wish to avoid a *"B"* reorganization so as to recognize the loss.

[14] Turnbow v. Commissioner, 368 U.S. 337 (1961).

ment to register is an agreement to pay the expenses of the registration and of the offering. Here the determining factor would be whether the acquiring corporation, in paying the registration and offering expenses, is discharging an obligation of its own or that of the stockholder. If the corporation permits the distribution of the shares without filing a registration statement, *it* will be in violation of the registration requirements of the Securities Act. Moreover, only an issuer can file a registration statement. Thus, since the corporation has a legal obligation to file a registration statement, it would not be paying the registration expenses to discharge a legal obligation of the stockholder, even though the stockholder must have the benefit of the registration statement in order to make a legal distribution of his shares. Registration expenses would include accounting fees, the issuer's legal fees, registration and Blue Sky fees, and printing costs. Other expenses which properly may be borne by the acquiring corporation include federal and state original issue taxes. On the other hand, it seems clear that the stockholders of the acquired corporation should pay underwriting commissions and discounts, finders fees, transfer taxes upon the transfer of their shares to the acquiring corporation, and fees of their own legal counsel in connection with the transaction; any attempt to shift such expenses to the acquiring corporation will give rise to "boot" and is to be avoided at all costs.[15]

If the acquired corporation has a relatively large number of stockholders the acquiring corporation cannot safely proceed to offer its shares on the basis of the private placement exemption. In close cases a corporation may seek a "no-action" letter from the Commission to the effect that if the facts are as represented, no administrative action will be taken against the issuer if an offering is consummated on a private placement basis. If this is not possible, a registration statement must be filed and the offering made to the stockholders of the corporation to be acquired. The registration

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[15] Treatment of premiums for insurance policies providing indemnification against Securities Act liabilities is troublesome. Such policies insure issuer, underwriter and if desired, selling stockholders. If the premium is a blanket one, no allocation or assumption by selling stockholders may be required; on the other hand, where selling stockholder coverage requires a separate premium, its payment by the issuer may be unwise.

The Commission formerly denied acceleration of registration statements for secondary offerings where selling stockholders did not pay their share of the expenses. This policy has now been rescinded.

statement involved will be particularly complex, since the prospectus must set forth information pertaining not only to the acquiring corporation but also to the corporation to be acquired. This is necessary in order to enable the stockholders to evaluate what they are surrendering as well as what they are getting. Quite obviously, such an exchange offering should have the cooperation, or at least the benevolent neutrality, of the management of the corporation which is being acquired.[16]

Assuming that the acquiring corporation encounters a cooperative management, its negotiators must approach certain controlling stockholders of the corporation to be acquired in order to solicit their cooperation and receive assurances that at least the minimum percentage of shares will be available at the outset of the offering. Are not these approaches unlawful as constituting the initial step of a general solicitation to all shareholders? The Commission in this case regards the controlling stockholders of the prospective acquired corporation as underwriters, thus permitting such discussions to fall within the exemption contained in section 2 (3) of the Securities Act.[17] Having been regarded as underwriters for this purpose, however, such individuals become underwriters for other purposes. For example, even though the shares offered to the stockholders of the acquired corporation are registered, any stockholder who has been classified as an underwriter will be unable to resell his shares unless the terms of his reoffering are set forth in the prospectus and he proposes to reoffer the shares immediately.[18] If he has no immediate intention of reselling the shares received in the reorganization, then such shares may have to be reregistered prior to their disposition, or at least resold with a section 10 (a) (3) prospectus.[19]

[16] There have been instances where a corporation sought to obtain control of a second corporation against the wishes of the management of the corporation to be acquired. In such a case, information concerning the acquired corporation may be difficult to obtain and may have to be confined to published information, assuming that the acquired corporation is sufficiently large to be described in financial manuals or to have filed reports with the Commission under any of the several applicable acts. Moreover, the management of the corporation to be acquired, in addition to circularizing stockholders in opposition, can devise many roadblocks, such as stock splits and dividends, which will upset the exchange ratios.

[17] 68 Stat. 683 (1954), 15 U.S.C. § 77(b)(3) (1958). That section excludes from the definition of sale and offer to sell, "preliminary negotiations or agreements between an issuer . . . and any underwriter . . . ."

[18] A stockholder who has not been classified as an underwriter may resell at any time, without being subject to such restrictions.

[19] That is, a prospectus containing current information concerning the company as

Of course, if the individual holds the shares for a sufficient period of time it will be presumed that he did not take with a view to distribution, and he then will be free to dispose of the shares upon the same basis as any other stockholder.

Controlling stockholders of the acquired corporation should, if possible, require the acquiring corporation to agree that it will register their shares in a secondary offering upon their request at any time within one or two years from the date of the tax-free exchange. It is also customary for the acquiring corporation to give such stockholders so-called "tag along" rights to have their stock registered in the event that the corporation for any reason files a registration statement for an offering of its stock; such rights are normally effective for a period of three years from the date of the tax-free exchange. In these cases it is not clear whether the payment of registration expenses by the acquiring corporation would constitute "boot" and retroactively disqualify the original reorganization from its tax-free status. It is true, of course, that registration of the shares, even under these circumstances, serves to protect the acquiring corporation from the claim that it has violated the Securities Act by issuing shares to a person taking with a view to distribution, thus justifying payment of the expenses by the corporation in order to satisfy its own legal obligations. The Service has informally agreed that "boot" does not exist where the acquiring corporation has already registered its outstanding voting shares of the same class (either wholly or in part), so that registration of the new shares merely gives them the same status as that of the outstanding shares. But where no outstanding shares of the acquiring corporation have been registered (for example, where publicly held stock was outstanding prior to 1933), the situation becomes questionable.[20] The safer course of action for the stockholder is to pay his proportionate share of the overall registration expense for the offering.[21]

required by § 10(a)(3) of the Securities Act. 68 Stat. 685 (1954), 15 U.S.C. § 77j(c) (1958).

[20] BNA TAX MANAGEMENT PORTFOLIO No. 78, pp. A-7, A-8. The BNA analysis suggests that in such cases the issuer's "commitment" to register all outstanding stock is required. This overlooks the fact that it usually is not possible to register outstanding, publicly held stock retroactively.

[21] If the proposed distribution and payment of registration expenses occurs more than three years after the tax-free acquisition, it is possible that the applicable tax limitation periods will have expired. But in that case, assuming that no pre-

RULE 133 TRANSACTIONS—"A" AND "C" REORGANIZATIONS

If the acquiring corporation wishes to avoid registration statement problems, it may have available two other reorganizational choices, the statutory merger and the quasi, or practical, merger.[22] Of course, in order for the corporation to avail itself of these methods, such procedures must be possible under the corporate laws of the states of incorporation. Under the statutory merger procedure, stockholder votes will be required on the part of both corporations, with concomitant rights of appraisal for dissenters; under the practical merger, a stockholder vote ordinarily will be necessary only in the corporation to be acquired.[23] Under both statutory and practical mergers the issuing of shares pursuant to a proposal which has been submitted to a vote of the stockholders is not considered a sale for purposes of the registration requirement of the Securities Act[24] by reason of the provisions of rule 133.[25] Rule 133 exempts not only the issuance of the shares by the surviving corporation to the acquired corporation, but also the subsequent distribution of the shares by the latter corporation to its stockholders in dissolution. Much has been written about the propriety or advisability of the adoption of this rule, and it is not the purpose of this article to review the arguments. The Commission adopted rule 133 in order to facilitate (by relief from the registration requirements of the Securities Act) the obtaining of stockholder votes in connection with corporate reorganizations involving issuance of securities.[26] The rule

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arranged plan or original intent to distribute existed, it is possible that no registration of the shares will be required.

[22] See INT. REV. CODE OF 1954, §§ 368(a)(1)(A), (C).

[23] Under a "*B*" reorganization, no stockholder votes are required unless, of course, additional shares must be authorized or unless the acquiring corporation is required to obtain a vote of its stockholders by reason of rules of the exchange on which its stock is listed. For example, the rules of the New York Stock Exchange and the American Stock Exchange require that stockholder approval be obtained by an acquiring corporation where it must issue a number of new shares equal to 20% or more of its presently outstanding shares. A stockholder vote of the acquiring corporation in a "*C*" reorganization may also be required in certain instances. See text accompanying note 37 *infra*.

[24] The issuance is still a sale for other purposes, such as § 12(2) dealing with civil liabilities; thus misrepresentations in proxy material might support an action for rescission or damages.

[25] 17 C.F.R. § 230.133 (1964).

[26] Rule 133(a) provides as follows: "For purposes only of section 5 of the act, no 'sale', 'offer', 'offer to sell', or 'offer for sale' shall be deemed to be involved so far as the stockholders of a corporation are concerned where, pursuant to statutory provisions in the State of incorporation, or provisions contained in the certificate of incorporation, there is submitted to the vote of such stockholders a plan or agree-

is based upon the proposition that the submission of matters to a vote of the stockholders is not a solicitation of the sale or purchase of the security, since the decision does not depend upon the volition of each individual stockholder, but rather upon the volition of the stockholders taken as a whole. Moreover, such a vote can bind dissenting stockholders, subject to their appraisal rights. The rule had its genesis in Note 5 to Form E-1, the general registration form for securities during the early years of the Securities Act. The rule was adopted as such in 1951, was modified in 1954 to conform to changes in the Internal Revenue Code,[27] and was extensively overhauled in 1959 as a result of *SEC v. Micro-Moisture Controls, Inc.*[28] and *Great Sweet Grass Oils, Ltd.*[29] It applies to "*A*" and "*C*" reorganizations under the Internal Revenue Code.[30] It should be noted that the rule could apply to "*C*" type reorganizations even where, for some technical reason, the reorganization involved is not tax-free.[31]

Under rule 133, while any ordinary stockholder of the acquired corporation may, after reorganization, freely dispose of the shares of the acquiring corporation which he receives, controlling persons of the acquired corporation, defined as "affiliates" thereof, are not

ment for a statutory merger or consolidation or reclassification of securities, or a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person or voting stock of a corporation which is in control as defined in section 368(c) of the Internal Revenue Code of 1954, of such other person, under such circumstances that the vote of a required favorable majority (a) will operate to authorize the proposed transaction so far as concerns the corporation whose stockholders are voting (except for the taking of action by the directors of the corporation involved and for compliance with such statutory provisions as the filing of the plan or agreement with the appropriate State authority), and (b) will bind all stockholders of such corporation except to the extent that dissenting stockholders may be entitled, under statutory provisions or provisions contained in the certificate of incorporation, to receive the appraised or fair value of their holdings."

[27] The stock issued under a "*C*" reorganization may now consist of stock of a corporation in control of the acquiring corporation. INT. REV. CODE OF 1954, § 368(a)(1)(C).

[28] 148 F. Supp. 588 (S.D.N.Y. 1957).

[29] 37 S.E.C. 683 (1957).

[30] The rule also applies to reclassifications of securities and other recapitalizations of a corporation with which we are not now concerned.

[31] A "*C*" reorganization may lose its tax-free status if substantially all the assets of the acquired corporation are not acquired, or if any additional property or securities distributed to shareholders, plus liabilities assumed by the acquiring corporation, exceed 20% of the value of the assets transferred. Nonetheless, rule 133 applies if the proposal is submitted to a stockholder vote pursuant to legal requirements and securities of the acquiring corporation, or voting stock of a corporation controlling such acquiring corporation, are distributed.

free to distribute. Such persons are deemed to be underwriters of any shares which they receive in the reorganization. Thus, unless they take the shares for investment and hold them for a considerable period, such shares will have to be registered prior to redistribution. Rule 133 (d) provides an escape hatch, however, whereby controlling persons may resell a limited number of shares in unsolicited brokerage transactions; in the case of an unlisted company, the limit is one per cent of its outstanding stock of the same class in any six-month period, while in the case of listed companies, there may be sold in a six-month period the lesser of one per cent of such outstanding capitalization or the highest number of shares traded on all exchanges in any one of the four weeks preceding the date of the sell order. This section is patterned after rule 154[32] which governs unsolicited brokerage transactions.

Although rule 154 is solely for the protection of the broker who sells stock for a controlling person,[33] rule 133 is clearly for the benefit of the controlling person of the acquired corporation. However, as is the case with rule 154, two caveats are necessary. The first concerns the concept of "distribution." Even though the rule spells out the permissible dispositions during any consecutive six-month period which do *not* constitute a distribution, it seems equally clear that sales up to the maximum permissible limits in succeeding six-month periods may well constitute a distribution.[34] In short, rule 133, like rule 154, is designed to accommodate sporadic sales; utilization of the exemption on a systematic basis every six months destroys the casual nature of the sales and therefore the exemption.

The second problem revolves around the meaning of the word "person" contained in rule 133 (d). While the rule permits unsolicited brokerage transactions within the specified limits by a "person," the word "person" is construed in the plural as well as the singular;[35] consequently, sales by certain controlling persons are lumped together in order to determine whether the permissible

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[32] 17 C.F.R. § 230.154 (1964).

[33] SEC Securities Act Release No. 4669, Feb. 17, 1964; 1 Loss, Securities Regulation 697 (1961) [hereinafter cited as Loss]. A controlling person of an acquired corporation may also be or become a controlling person of the surviving corporation. When such a person sells in unsolicited brokerage transactions, either rule 154 or rule 133 may be applicable, but the exemptions may not be cumulated.

[34] SEC Securities Act Release No. 4669, Feb. 17, 1964.

[35] PLI, S.E.C. Problems of Controlling Stockholders and in Underwritings 114-15 (1962).

limitations have been exceeded. It has always been clear, for example, that sales by persons belonging to a single economic unit, such as the family, should be lumped together. But how should sales by common affiliates of the acquired corporation be treated? The Commission has wrestled with this problem for some time, and in the past it has simply tried to determine what constitutes a "reasonable grouping of people." Very recently, it has indicated that the word "person," for purposes of rule 154, really means "group of closely related persons."[36] The constituency of these groups must still be worked out in each particular case. It may include persons closely related by kinship where they held executive positions with the acquired corporation and received shares in a rule 133 transaction. It may include close business associates. On the other hand, different sets of control groups of the acquired corporation may be considered separately.

Where a controlling person of an acquired corporation wishes to make larger dispositions than are permitted by rule 133, it is possible in certain situations to resell the stock immediately through an S-14 registration statement,[37] which involves use of the so-called "wrap-around prospectus." In such cases, if the acquiring corporation is a listed company and if its acquisition of the acquired corporation was pursuant to or authorized by a vote of the stockholders of the acquired corporation, then the proxy statement used in connection with the proxy solicitation may be used by the controlling person as the nucleus of the required prospectus. Where the reorganization was a statutory merger, a vote of the stockholders of the acquiring corporation would also have been required. In the case of an acquisition of assets for stock, however, a vote of the stockholders of the acquiring corporation would not have been required except in two instances: (1) where shares to be issued in the acquisition had to be authorized by its stockholders, and (2) where the issuance of the shares had to be approved by the stockholders in accordance with the rules of the exchange upon which the stock of the acquiring corporation is listed. If registration on Form S-14 is accomplished, the prospectus must be maintained current for a period of two years from the effective date of the registration statement, and for as long thereafter as the distribution of shares re-

[36] SEC Securities Act Release No. 4669, Feb. 17, 1964.

[37] Unless the secondary offering is underwritten, the stockholder will be subject to the hazards discussed in the text accompanying notes 11-12 *supra.*

ceived in the reorganization continues. Such an undertaking in effect requires the filing of supplemental prospectuses pursuant to section 10 (a) (3) of the Securities Act.

As is the case with the *"B"* reorganization, it is customary in reorganization agreements following the *"A"* or the *"C"* route to include in the covenants of the acquiring corporation an agreement that the shares will be registered at the request of controlling stockholders of the acquired corporation at any time within a specified period beginning with the date of the acquisition. It is also customary for the acquiring corporation to require persons who control the acquired corporation at the time of the stockholder vote authorizing the reorganization to represent that they are taking the shares acquired with a view to investment and not for distribution (subject to any rights under rule 133 (d)), and further, that no distribution of the shares acquired in the reorganization will be made within a specified period of time, usually two years from the date of acquisition, without an opinion of counsel to the effect that such disposition will not be in violation of the Securities Act.

An agreement to register which is coupled with an agreement to pay the expenses of registration poses "boot" questions which are similar to those encountered in the *"B"* reorganization, but which have a somewhat lesser impact. Contrary to the *"B"* reorganization, "boot" may be received in a *"C"* reorganization provided that "substantially all" of the corporation's assets are acquired pursuant to the plan of reorganization. In a *"C"* reorganization the liabilities as well as the assets of an acquired corporation may be assumed by an acquiring corporation, and such assumption will not destroy the reorganization. On the other hand, if additional consideration is paid to the shareholders of the acquired corporation, then such additional consideration, or "boot," plus the liabilities assumed, cannot exceed twenty per cent of the value of the assets acquired. Thus, in cases where assumed liabilities exceed twenty per cent of the value of the assets acquired (which is probably true in most cases), payment of the registration expenses by the acquiring corporation could vitiate the tax-free character of the transaction. In such cases the same analysis applies as that under a *"B"* reorganization. The acquiring corporation will be discharging an obligation of its own in paying most of the expenses of the registration. Only those expenses of the affiliates of the acquired corporation which are peculiar to them, such as fees of their counsel, should be borne by them. The better view is that agreements to register plus payment of the general registration expenses do not constitute "boot" in the *"C"* reorganization.

Under an *"A"* reorganization, or statutory merger, the "boot" problem does not arise. Any extra consideration received by stockholders of the acquired corporation is taxable to the recipients as either capital gain or ordinary income. However, the receipt of "boot" does not destroy the basic tax-free nature of the statutory merger.

DIFFERING POSITIONS OF THE SHAREHOLDER IN A "B" REORGANIZATION AND A RULE 133 TRANSACTION

From the standpoint of the acquiring corporation, the *"A"* and *"C"* reorganizations constitute the line of least resistance in a corporate acquisition so far as immediate securities problems are concerned. This advantage must be discounted by the necessity of securing stockholder approvals, providing appraisal rights for dissenters, and assuming liabilities of the acquired corporation (subject to warranties of the acquired corporation and its shareholders). Moreover, the transaction will generally be more complex than a *"B"* reorganization.

Insofar as the controlling stockholder of the acquired corporation is concerned, the brokerage transactions exemption contained in rule 133 should dictate his preference of the merger or asset acquisition over the *"B"* reorganization, at least where there is no immediate prospect of a registered offering of the shares acquired. Where the acquiring corporation is an unlisted company and the number of shares acquired in the reorganization is very large, this advantage may be more illusory than practical in view of the inherent difficulties in effecting unsolicited brokerage transactions in the over-the-counter market. For one thing, the broker-dealers who make the market may be unwilling to drop out of the market for the period of time necessary to effect an unsolicited brokerage sale for the selling stockholder.[38] Further, the market may be thin and unable to support dispositions of more than a few hundred shares. Where the acquiring corporation is a large listed company, however, the mechanics of effecting the brokerage transaction are easy

[38] A broker-dealer making a principal market, by definition, is engaged in solicitation. SEC Securities Act Release No. 4669, Feb. 17, 1964.

to accomplish, since such transactions effected in the regular manner will, by definition, fulfill the requirements of rule 133. Moreover, the market will not only be able to absorb sales of the acquired securities, but the permissible rule 133 sales limits based upon trading volume will normally be quite high.

It has been suggested that in the case of an acquired corporation with a small number of shareholders, each owning substantial amounts of its stock, rule 133 may not be applicable; if that were the case, the benefits of rule 133 (d) and (e) would not, of course, be available. This contention is based upon the proposition that where a few stockholders hold such substantial blocks of stock as to assure practical consummation of the reorganization, the transaction partakes more of the nature of a negotiated private transaction than of a transaction submitted to stockholders for corporate approval. This position can only be understood in light of certain cases arising during the mid-1950's.[39] Prior to those cases, there was a prevalent misconception that rule 133 not only exempted the transaction whereby a reorganization proposal was presented to stockholders, but also permanently exempted from registration the shares issuing out of the reorganization, regardless of the circumstances of their disposition.[40] Promoters, in order to evade registration requirements, would either organize a new corporation or acquire an old shell corporation for the purpose of purchasing the assets of another corporation in exchange for shares of the new or shell corporation. These shares would then be publicly marketed, supposedly exempt from registration. Such transactions were characterized not only by lack of registration of the securities, but also by fraud and misrepresentation in connection with the subsequent distribution. Even with rule 133 in its relatively primitive state, the Commission had ample weapons in its arsenal to deal with such situations. For example, with regard to the abuses described above, the controlling persons of the acquired corporation would be regarded as underwriters in the transaction. Thus, subsequent distributions of shares by them pursuant to the plan would be subject to registration. Moreover, such persons would in most cases be controlling persons of the acquiring corporation and, accordingly, would be required

[39] Cases cited notes 28-29 *supra*.

[40] It was recognized, of course, that a preconceived plan to acquire a shell corporation for the purpose of reorganizing with another would constitute the promoters of the shell corporation underwriters.

to register the shares upon their disposition. Rather than confining its retaliation to these grounds, however, the Commission, in the leading case of *Great Sweet Grass Oils, Ltd.*,[41] went on to state, by way of dictum, that:

> In any event, where the persons negotiating an exchange, merger or similar transaction have sufficient control of the voting stock to make a vote of stockholders a mere formality, Rule 133 does not apply.[42]

This statement and others like it have caused much subsequent confusion, if not mischief. For example, assume that two-thirds or more of the stock of an acquired corporation is owned by one or two stockholders and the remainder by a relatively small number of other shareholders. In such a case there should be no question but that the transaction is covered by rule 133, even though corporate approval is a foregone conclusion. Another case in which confusion has been created by the Commission's statements is that of the acquired corporation with a half dozen or so shareholders, each owning an equal amount of stock. Is an exchange involving this type of corporation to be considered a "negotiated" transaction as opposed to one consummated as a result of corporate approval?

The present version of rule 133 is designed to cover affiliates of the acquired corporation who take other than with a view toward investment. By virtue of their classification as statutory underwriters,[43] such persons are normally unable to dispose of the shares received without registration. Likewise, any person taking from such a stockholder immediately after the reorganization with a view to distribution becomes an underwriter.[44] While the "negotiated sale" doctrine may still in rare cases be regarded as an implied exception to the applicability of rule 133, it can be stated that because of the amendment of that rule in 1959 placing restrictions on affiliates, the Commission should be less concerned about applying the doctrine, since the amendment clearly has precluded the abuses formerly feared by the Commission.[45]

If the foregoing view is correct, there are marked substantive

[41] 37 S.E.C. 683 (1957).
[42] *Id.* at 691.
[43] SEC Rule 133 (c), 17 C.F.R. § 230.133 (c) (1964).
[44] SEC Rule 133 (b), 17 C.F.R. § 230-133 (b) (1964).
[45] See PLI, S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 125-26 (1962); see also 1 Loss 529-39.

differences between the various modes of reorganization from the standpoint of the stockholder of the acquired corporation, even when that corporation is closely-held. The *"A"* and *"C"* reorganizations may permit a relatively easy disposal of some of the shares obtained. The *"B"* reorganization, on the other hand, offers the prospect of having to hold such shares for whatever period of time may be deemed necessary to demonstrate bona fide investment intent.

CONCLUSION

The federal securities laws leave the stockholder of an acquired corporation in an unenviable position. He is uncertain in many instances of his legal status and the measures which he must take in order to protect himself. He may be unable, because of a weak bargaining position, to exact from the acquiring corporation the agreements necessary to protect his legitimate interests. Even where compliance with registration requirements is undertaken by the issuer, the stockholder of the acquired corporation is forced to sell his shares at a time when he may not wish to do so. Registration for gradual disposition as the stockholder pleases, even when technically available, is practically and legally difficult, particularly when the dispositions are to be effected in the over-the-counter market.

It is open to argument whether Congress intended this result.[40] At the least, the requirement that shares received in corporate reorganizations be registered prior to their resale takes no cognizance of the wide public dissemination of financial information on listed and unlisted companies effected by the Exchange Act. The Commission constantly cites the "public interest" as justifying ever increasing controls over the securities industry and the distribution and trading of securities. The number of stockholders of acquired corporations has increased markedly in recent years (as corporate acquisitions become the conventional method of corporate expansion), and there may be emerging a second, not necessarily conflicting, public interest to which Congress should direct its attention.

[40] Dean, *Twenty-Five Years of Federal Securities Regulation by the Securities and Exchange Commission*, 59 COLUM. L. REV. 697, 727 (1959).