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Incorporation and the Securities Acts

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ATTORNEYS, when advising clients regarding the advantages and disadvantages of incorporating a business, must carefully consider the applicability of the securities laws, state and federal, to the venture from its inception. If a business were run as a proprietorship or a general partnership, the principals could dispose of their interests in the business without consideration of the securities laws. The issuance of stock by a corporation to such individuals in exchange for cash or their interests in the business triggers the application of both state and federal securities laws. More importantly, however, the attorney must recognize that these statutes will certainly regulate, and perhaps hamper, the former proprietors or partners, now shareholders, ability to dispose of their shares.

The state securities statute, or blue sky law, will certainly apply to both the initial issuance of securities by the corporation and to any sale of the shares by the shareholders.[1] And the Securities Act of 1933[2] (hereinafter the 1933 Act) will in all likelihood also apply. Section 5(a) of the 1933 Act provides in part that unless a registration statement is in effect "it shall be unlawful for any person . . . to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security . . . ."[3] The breadth of this interstate commerce provision means that almost all security sales will be regulated by the 1933 Act. Use of the mails, or the telephone, in connection with the transaction[4] is sufficient to make applicable the registration provisions of the 1933 Act.

Among the proscriptions in both the state and the federal schemes is the offer or the sale, either by the corporation or a shareholder, of securities unless they are registered, or fit within an exemption from registration. The further complication for the selling shareholder is that under the federal system generally only the corporation can register the securities.[5]

The consequence of selling securities without complying with the terms of these statutes can be serious. Under the Virginia statute the seller can be liable for civil damages[6] or perhaps criminal penalties if intent to defraud is shown.[7] Likewise, under the federal system, civil and criminal penalties are available as is recession of the transaction in which the securities were issued.[8]

The registration process is quite detailed, especially under the federal system, and can entail significant expense both of money and of management and attorney time.[9] Moreover, it exposes the corporation and the individuals involved to significant liabilities.

Obviously, the initial capital funding of all corporations would be greatly hampered if there were not some relief from the strictures of these statutes. Fortunately, there are exemptions from the registration provisions which meet the corporation's needs in the issuance transaction and, though less clearly, also cover the resales of the securities by the initial shareholders.

Exemption from the state registration requirement is quite clear. Virginia Code Section 13.1-514(b) lists twelve transactions in which the sales of securities are exempt from registration. The exemption most relevant to this discussion is contained in Section 13.1-514(b)(8), the Virginia enactment of a "private offering" exemption. Briefly, it exempts sales by issuers if after the sale the issuing corporation has not more than 35 shareholders and if the company has not offered its securities to the general public by advertisement or solicitation. Literally this provision allows the corporation to issue securities to an unlimited number of people so long as at no time there are more than 35 shareholders and no offer has been made to the general public. However, if the securities are offered to more than 35 people, there may have been an offering to the general public.[10] In any event the initial capital can be contributed in exchange for shares free of registration if there are not more than 35 subscribers. Of course, this is most typically the case on incorporation.

In addition, Section 13.1-514(b)(11) exempts the issuance of not more than three shares of common stock to one or more incorporators and the initial transfer thereof. This section exempts the issuance of at most three shares. If the initial subscribers in a closely held corporation are three or less, each could be listed as an incorporator in the articles of incorporation and issued one share exempt from registration. Obviously, this exemption is not available if there are more than three shareholders or if the issuance of more than three shares is necessary to achieve some relative proportionate share ownership. It has an advantage inasmuch as it also exempts the first transfer by the subscriber-incorporator. Additional shareholders could be added later, up to 35, under the private offering exemption contained in Section 13.1-514(b)(8).

The shareholders receiving shares under Section 13.1-514(b)(8), and the incorporators whose resale might fit within Section 13.1-514(b)(11) as well, can dispose of their shares without registration pursuant to Section 13.1-514(b)(1). This section exempts any isolated transfer by the owners of shares whether effected privately or through a broker-dealer so long as the transfer is not directly or indirectly for the benefit of the issuer. The burden of proving this or any other exemption is on the person claiming it. The question of whether transfer is directly or indirectly for the benefit of the insurer is an elusive factual one. The shareholder's intention at the time of the acquisition of the shares is highly relevant in this regard. The shareholder may satisfy this element of the exemption if, at the time he acquired the shares, he did not intend to be party to a plan of distribution for the issuer's benefit. The fact that he later does sell the shares does not necessarily imply that they were sold for the benefit of the issuer. One simple way to prove the requisite investment intent is to ask the shareholder to sign an investment letter in which he recognizes that the shares have not been registered either under the 1933 Act or the state statute, represents that he is acquiring the shares for investment only and not for purposes of distribution or resale, and agrees not to sell the shares unless they are registered, except in an exempt transaction. Also the securities ought to be legended setting forth the substance of the investment letter.[11]

Transactions specified in the enumerated subsections of Section 13.1-514(b) are exempted from the securities registration requirements and in most instances from the broker dealer registration requirements. The remaining provisions of the Virginia statute, however, including in particular the general anti-fraud provisions,[12] remain applicable. Thus, although the corporation, or a shareholder, has the ability to sell the securities without registration, misrepresentations in connection with the sale would still violate the statute.

Under the 1933 Act, the same issues arise as under the blue sky laws, how can a corporation issue shares on incorporation and how can the initial shareholders safely resell them, both without registration.

In this context, basically two exemptions from registration are available. The first, for which there is understandably no analog in the state regulatory scheme, is the intrastate offering exemption.[13] This exemption provides that the 1933 Act not apply to securities which are issued or sold only within the state in which the issuer is incorporated and is doing business. The intrastate offering exemption is contained in Section 3(a) of the 1933 Act which purports to exempt certain classes of securities from the provisions of the 1933 Act. This section is distinguished from Section 4(2), in which the other principal available exemption, the private offering exemption, is contained. Section 4 provides only that the registration provisions of Section 5 are inapplicable to the four types of transactions listed therein. The distinction apparently to be drawn is between exempt securities on the one hand and exempt transactions on the other. Under the former the security itself is exempt. The types of transactions, by issuers, underwriters, etc. in which they are transferred is not important. Moreover, the other provisions of the 1933 Act, except some of the anti-fraud provisions, are inapplicable. Whereas the latter exempts only certain types of transactions in which the securities are transferred from the registration provisions of Section 5 of the 1933 Act. All of the remaining provisions, including all of the anti-fraud provisions, apply.

Although the intrastate offering exemption is contained in the exempt security section, it is nonetheless treated as an exempt transaction, thus enjoying the more limited advantage of exemption only from registration.[14]

The vague statutory language of this and the other exemptions has troubled practitioners, the courts and even the Securities and Exchange Commission for years. There is a particular risk for the practitioner and his client since they have the burden of demonstrating entitlement to the exemption; and the exemption is to be strictly construed. The Securities and Exchange Commission has promulgated Rule 147[15] in an attempt to clarify the meaning of the exemption and to set its parameters.[16]

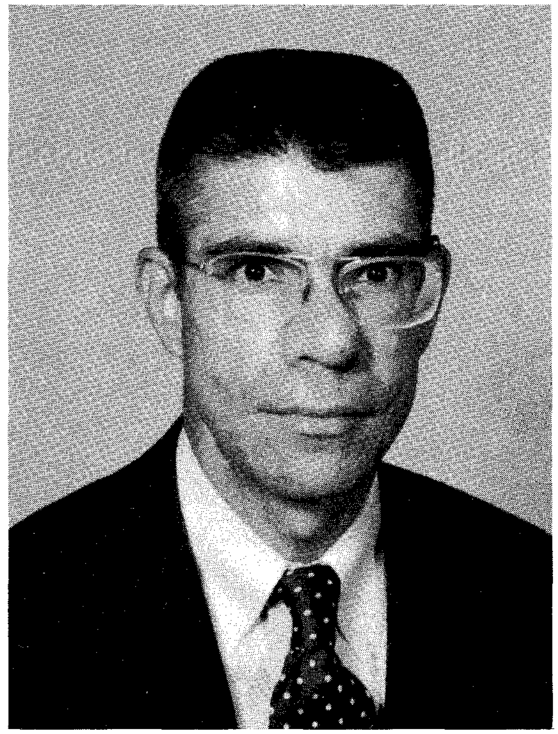
Briefly the Rule provides that an issuer may offer to sell and may sell securities to persons who are residents of the same state in which the issuer is a resident and is doing business. A newly formed corporation can satisfy this requirement if it is doing business within the state after the sale of securities.[17] Thus offers and sales of securities may be made to an unlimited number of people so long as they are all residents of the same state, and that state is the same as the state in which the issuer is a resident and is doing business. An offer or sale to one non-resident disqualified the entire issue. The corporate issuer is a resident of its state of incorporation; it is doing business in the state in which its place of business (80% of its revenues and assets) is located and 80% of the proceeds from the offering are to be used.[18] Individual shareholders are residents of the state of their principal residence; and corporate or partnership shareholders are residents of the state in which *all* of their beneficial owners are residents.[19]

In addition, an offering will be integrated with all offers or sales registered, or made pursuant to any other exemption, made within six months before or after the offering in question, and with any offers or sales of securities during this twelve month period, if they are of the same or similar class securities as those of the offering in question. If any of these transactions do not meet the criteria of Rule 147, the exemption is not available for the offering in question.[20]

This exemption, thus, is quite narrow, but is available if the corporation and all persons to whom the shares are offered are residents of the same state. A later transfer of shares to a non-resident does not destroy the exemption so long as they are held by residents for nine months and are not transferred as part of a plan to distribute to non-residents. Sales to residents may be made during the nine months period.[21]

The other exemption from registration pertinent in this regard is the private offering exemption pursuant to Section 4(2) of the 1933 Act, which exempts from the registration requirements of Section 5 "transactions by an issuer not involving any public offering."[22] As noted in *SEC* v. *Ralston Purina Co.*[23] the purpose of the 1933 Act is to protect investors by requiring that issuers provide investors with full and complete disclosure regarding their investment decisions. The court in that case indicated that the Section 4(2) private offering exemption applied only to offerings made to people who do not need the protection afforded by the registration requirement, because they have access to the required information and they are capable of fending for themselves.[24] As with the intrastate offering exemption, the plethora of commentary and administrative and judicial opinion have not defined the parameters of this exemption and of the *Ralston Purina* test. The Commission, in an attempt to provide some objective criteria and to provide a safe harbor for certain private transactions, promulgated Rule 146.[25] However, one may attempt to take advantage of this exemption, like the Rule 147 offering, without complying with the Rule by relying on the statutory exemption and the amplifying administrative and judicial opinions.

Briefly, Rule 146 contains six requirements: (i) no offer or sale can be made by any general solicitation or advertising by or on behalf of the issuer; (ii) the issuer must have reasonable grounds to believe that each offeree, prior to the offer and sale has either such knowledge and experience that he is capable of evaluating the merits and risks of the prospective offer or can bear the economic risk of the investment (prior to the sale, an offeree representative who meets the knowledge and experience test, may be appointed to



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assist an offeree); (iii) the offerees and any offeree representatives must have access to information regarding the issuer either through employment, familial relationship or economic bargaining power or he must be furnished certain of the information which would be required in a registration statement, to the extent the issuer possesses it or can obtain it without unreasonable expense; (iv) generally there can be a maximum of 35 purchasers; (v) essentially the same integration rule as applied to Rule 147 offerings must be met; (vi) the shares must be legended, stop transfer instructions be issued and an agreement must be obtained from the shareholder to the effect that he will not sell the shares without registration or pursuant to an exemption.[26]

Offering the shares on incorporation may fit within the Rule even though there may be very little information about the company.[27] Alternatively, the initial placement of securities may otherwise fit within the statutory exemption. Release 33-4552[28] states that sales to promoters taking the initiative in founding or organizing a business will come within the statutory private offering exemption. This release, however, does not form the basis of an exemption for the issuance of securities to otherwise uninformed or uninvolved individuals.

Resales of securities by the initial shareholders present another area of uncertainty. If the shares have not been registered, the shareholder can sell them only in a transaction that likewise is exempt from registration. For a shareholder in a small, closely held corporation resales may be even more difficult.

A shareholder might take advantage of Rule 144[29] which basically provides that after a two-year holding period, a certain quantity of securities can be sold each three months; although non-affiliates of the issuer may sell unlimited amounts of listed or NASDAQ securities after a three-year holding period. This rule is of limited use to a shareholder in a closely held corporation because it requires that the sales be made through a broker in transactions in which the broker simply executes the order to sell. It cannot solicit purchasers. The limited market for the shares in closely held corporations may make such broker transactions unlikely.

A second alternative is a sale pursuant to Rule 237.[30] Under this rule, a non-affiliate of an issuer, which has been in business for five years, who has held securities for at least five years, may sell during a year the lesser of $50,000 face value or 1% of the value of the outstanding securities. These sales, in contrast to the Rule 144 sales, must be in negotiated sales, other than through a broker or dealer. Again this rule is of limited use in the closely held corporation both because of the relatively small annual leak-out and the likelihood that most shareholders would be deemed affiliates of the issuer.

Lastly, and probably most importantly, sales may be made through a private offering. Despite the fact that the prior two options provide only narrow relief, the Securities and Exchange Commission has not articulated a safe harbor rule for private resales of securities.[31] Section 4(2) of the 1933 Act and Rule 146 are literally not available because both apply to transactions by issuers, not shareholders. The concensus appears to be that although private resales may be made pursuant to Section 4(1) of the 1933 Act, which exempts transactions by "any person other than an issuer, underwriter or dealer,"[32] the conditions which such sale must meet include some of those required by Section 4(2) and Rule 146.[33] Especially important is the holding period to determine if the shares were acquired with a view to distribution, or were held for investment, and number of purchasers and the manner of the sale.[34]

While this hybrid exemption is available to the holder of a relatively few shares who has had little influence in the management of the corporation, it will not be available to a person who is an officer, director or substantial shareholder, or is otherwise in control of the corporation. Unfortunately, this group includes many shareholders in the closely held corporation. The circumstances of an exemption by which they may resell their shares is arrived at more circuitously.

Section 4(1) is not available to such shareholders because that Section exempts sales by persons other than the issuer, a dealer or an underwriter. As will be seen, sales by these "control" persons may be hampered by the definition of an "underwriter." On the other hand, Section 4(2) and Rule 146 are not available as they exempt only "issuer" transactions. Rule 237 is also unavailable, because it excludes sales by "affiliates" which for this purpose includes control persons. There is support for the proposition that sales by control persons can safely be made only under Rule 144.[35] This conclusion places shareholders in the closely held corporation in an untenable position, since Rule 144 exempts only unsolicited transactions through a broker. Control persons, however, may use the intrastate offering exemption, if the sale meets the terms of the exemption. The S.E.C. has not clearly indicated how the controlling person is to meet the requirements of the exemption. In Release 33-4434[36] it stated that the primary focus is on whether the issuer meets the requirements of the exemption, not on the controlling person. That release authorized the sale by a controlling person who was not a resident of the same state as the issuer.[37]

The cause of the control person's predicament is the definition of "underwriter," and the control person's concern with this definition comes about rather obliquely. If he were unaffected by it, the 4(1½) exemption referred to above would be as available to him as to any other shareholder. Section 2(11) of the 1933 Act,[38] defines "underwriter" to include a person who has purchased securities from an issuer with a view to their distribution, or who offers or sells the securities for an issuer in connection with the distribution. As conceptually difficult as this language is, the problems of interpretation are compounded by the final sentence of the definition which states in part, ". . . the term 'issuer' shall include . . . any person directly or indirectly controlling or controlled by the issuer . . ."[39] Thus the control person is, for purposes of Section 2(11), an issuer. If a person purchases from the control person-issuer with a view to distribution, such person is a statutory underwriter, and sales by such person cannot take place in reliance on Section 4(1), since they would be sales by an underwriter. And the control person-issuer is responsible for the sales by such person.[40] Thus the control person-issuer must be certain that any purchaser from him does not intend any distribution. If the purchaser simply purchases for investment, he is not an underwriter, and the control person-issuer's responsibility for resales is reduced. Hence, the control person ought to be free to sell to a purchaser intending to hold the shares for investment.

Unfortunately, the term "control" is not defined for purposes of Sections 4(1) and 2(11). However, Rule 405,[41] in defining terms for registration requirements, states that "control" "means the possession, direct or indirect, of 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."[42] The term thus includes directors, most officers and significant shareholders.[43] Members of a controlling group are each control persons. The term control may thus include parties to a shareholder agreement if significant corporate matters are determined pursuant to the agreement, or if the corporation is run by shareholders without a board of directors, as provided in the close corporation statutes.[44]

The conclusion then is that the control person, as other shareholders, might be free to sell his shares in a transaction in which the purchaser takes for investment, as may be demonstrated by an investment letter and appropriate stop transfer legend on the securities.[49] It is unclear, as in the case of resales by others, whether other requirements of the Rule 146 private offering exemption, such as limitation on the number of purchasers, integration, and availability of information, are required.

Footnotes

1. Va. Code. Ann. §§ 13.1-501 to 13.1-527.3, in particular § 13.1-507 (1978). Since this article is necessarily brief, the descriptions of various statutory and administrative provisions is extremely sketchy. Reference to the text of these provisions and to other commentary, including that cited in this article, is necessary for a complete explication.
2. 15 U.S.C. §§ 77(a)-77(aa) (1976).
3. 15 U.S.C. § 77(e)(a) (1976).
4. *Lennerth* v. *Mendenhall,* 234 F. Supp. 59 (D. Ohio 1964).
5. The Virginia blue sky statute allows registration by others. Va. Code Ann. § 13.1-511 (1978).
6. Va. Code Ann. § 13.1-522(1) (1978).
7. Va. Code Ann. § 13.1-520(A) (1978).
8. 15 U.S.C. §§ 77(1), 77(x) (1976).
9. There are, however, simplified forms of registration which may be especially advantageous to the small, closely held corporation. For example, in the federal system a Rule 240 registration (17 C.F.R. § 230.240) of up to $100,000 worth of securities; a Rule 242 registration (17 C.F.R. § 230.242) of up to $2 million worth of securities, including that sold pursuant to certain other exemptions, during any six month period; or a Regulation A offering (17 C.F.R. § 230.251-263) of up to $1.5 million during a twelve month period, may be undertaken. See generally *The Virginia Lawyer,* ch. 23 (Michie-Bobbs Merrill, 1979); *What Every Lawyer Should Know About Securities Laws,* II 3-4 (The Virginia State Bar and The Virginia Bar Association, 1977). Although compliance with the provisions of these forms of registration is quite simple, they do require that the Securities Exchange Commission be notified of the offering. See generally Thomforde, *Exemptions from S.E.C. Registration for Small Business,* 47 Tenn. L. Rev. 1 (Fall, 1979).
10. The State Corporation Commission has taken this position. *The Virginia Lawyer,* supra note 9 at 23.18.
11. For a form of investment letter see *The Virginia Lawyer,* supra note 9 at 23.29 and 30. This letter, however, includes no reference to the Virginia statute.
12. Va. Code Ann. § 13.1-502 (1978).
13. 15 U.S.C. § 77(c)(a)(11) (1976).
14. Hicks, Exempted Transactions Under the Securities Act of 1933, § 1.01[3] (Clark Boardman Company, Ltd. 1979).
15. 17 C.F.R. 230.147 (1979).
16. Preliminary Note 1 to Rule 147 indicates that the Rule is not exclusive and that transactions not fitting within the Rule might still fit within the statutory exemption, if they meet the conditions stated in the various administrative and judicial interpretations. However, the burden rests with the person claiming the exemption. Thus this Rule, as the other 140 Series Rules, provides "safe harbor" within which transactions covered can be conducted.
17. Hicks, *supra* note 14 at § 4.04[3][c][i].
18. 17 C.F.R. 230.147(c) (1979).
19. *Id.* at 147(d).
20. *Id.* at 147(b)(2). This integration concept can become extremely complex. For a good explanation of it in several fact settings see Hicks, *supra* note 14 at § 4.03[3].
21. *Id.* at 147(e).
22. 15 U.S.C. § 77(d)(2) (1976).
23. 346 U.S. 119 (1953).
24. *Id.* at 125, 127.

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ABA—Hawaiian Style

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to the Young Lawyer's Section's sense of creativity and ability to pursue their goals.

I could go on, but the case has been made by citing the many varied and meaningful accomplishments of your Association. And I need not elaborate upon the lasting friendships that are created and nurtured at our mid-winter meetings at Williamsburg and our mid-summer meetings at The Homestead and The Greenbrier.

Virginia's New Law School

On August 23rd I attended the dedication of The George Mason School of Law, in Arlington, Virginia, which, in 1979, became the Commonwealth's third public law school by act of the General Assembly. The dedication had been postponed while George Mason (formerly known as The International School of Law) sought and obtained A.B.A. accreditation. Such accreditation was formally resolved by the A.B.A. in early August, 1980.

With, I trust, pardonable pride, since I have been an Arlingtonian for 33 years, we welcome the dedication of George Mason School of Law, which is centrally located in the Northern Virginia area, where approximately 20% of Virginia's population resides. The Editor of our *Bar Journal*, Charlie Friend, is a member of its faculty. I know that Charlie and George Mason's Dean Ralph Norvell will assist Hugh Patterson, Emerson Spies and me in involving our new law school's faculty and students in our C.L.E., Marshall Fellows and other programs, so that the law school and we may be mutually inspired and strengthened.

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25. 17 C.F.R. 230.146 (1979).
26. *Id.* at 146(b) through (h).
27. There is nothing in the rule itself to make it inapplicable to initial offerings.
28. S.E.C. Release 33-4552 (Nov. 6, 1962); 1 CCH Sec. L. Rep. Par. 2774.
29. 17 C.F.R. 230.144 (1979).
30. 17 C.F.R. 230.237 (1979).
31. See generally, Sargent, *The Federal Securities Laws and Small Business,* 33 Bus. Law 901 (1978); Kinderman, *The Private Offering Exemption: An Examination of Its Availability Under and Outside Rule 146,* 30 Bus. Law 921 (1975).
32. 15 U.S.C. § 77(d)(1) (1976).
33. This private resale exemption is popularly referred to as the Section 4 (1½) exemption. For a discussion of this exemption as well as the recommended structuring of transactions to take advantage of it see *The Section "4 (1½)" Phenomenon: Private Resale of "Restricted" Securities,* 34 Bus. Law 1961 (1979).
34. *Id.* at 1975-6.
35. 2 Goldberg, PRIVATE PLACEMENT AND RESTRICTED SECURITIES, § 4.3[e] (Clark Boardman Company, Ltd., rev'd ed. 1979). 1 CCH Fed. Sec. L. Reptr. Par. 2706.02.
36. S.E.C. Release 33-4434 (December 6, 1961); Hicks, supra note 14 at § 4.02[2].
37. *Id.*
38. 15 U.S.C. § 77(b)(11) (1976).
39. *Id.*
40. *United States* v. *North American Research & Development Corporation,* 424 F.2d 63 (Ind. Cir. 1970); *United States* v. *Wolfson* 409 F.2d 779 (2nd. Cir. 1968); Bloomenthal, 3 *Securities and Federal Corporate Law* § 4.08[2] (Clark Boardman Company, Ltd. 1977).
41. 17 C.F.R. 230.405 (1979).
42. *Id.* at 230.405(e). An "affiliate" is a person who controls or is controlled by the person specified. *Id.* at 230.405(a).
43. For an extensive discussion and explanation of the term control see Somner, *Who's "In Control"?—S.E.C.,* 21 Bus. Law 559, 565 (1966).
44. See e.g. DEL. CODE ANN. tit. 8 §§ 341-356 (1975).
45. Somner, supra note 43, at 583.