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The Public Offering and a Quest for Alternatives

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I. INTRODUCTION

The year 1969 has seen a continuation of the strong new issues market that has commanded a significant portion of the attention of the investing public over the past few years. As a result, more and more closely held companies are seeking to raise funds through public offerings of their stock and thus share in the successes of this strong market. While the market conditions have been most encouraging, there have been other developments that have made the managements of some closely held companies reconsider the relative advantages and disadvantages of going public. Recent court decisions have strictly defined the legal responsibilities and potential liabilities of management of publicly held companies. The costs of going public, both in money and in the time of management, have also steadily increased. Moreover, these trends seem likely to continue as more extensive reporting requirements are applied to public companies under the federal securities laws.

What is the real substance of these new cases and the costs of being a publicly held company? What is behind the furor over such cases as *BarChris*,[1] *Globus*[2] and *Texas Gulf Sulphur*?[3] Are accountants, underwriters, lawyers, and corporate executives now required to meet impossible standards in the preparation of a registration statement and are they subject to substantial liabilities for any failure to fulfill these standards? Perhaps most importantly, how do these new developments affect the varied and interdependent questions and considerations against which a decision to go public has traditionally been measured?

The purpose of this article is to answer some of these questions. It will analyze the advantages and disadvantages of going public in the

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1. Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

2. Globus v. Law Research Serv. Inc., 287 F. Supp. 188 (S.D.N.Y. 1968), *rev'd in part*, CCH FED. SEC. L. REP. ¶ 92,474 (2d. Cir. Sept. 9, 1969).

3. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

context of these new cases and in the context of these increasing costs. It will then compare the results of going public with the results obtained by some other means of raising capital for closely held companies. From these analyses the reader can reach some conclusions as to the best course of action for his client or company to follow.

In this discussion, the focus of attention will be upon a small, closely held hypothetical corporation called Essex Industries, Inc. Essex is owned and operated by two stockholders whose wives and children also hold nominal amounts of stock. Essex currently maintains one plant, which also includes its executive offices. Its owners are both early middle age, but several of their key subordinantes are younger men, unrelated to the principals, who it is felt must take leading roles in any expansion of the business.

For its last fiscal year, Essex had after-tax income of 800,000 dollars on sales of 7,000,000 dollars, representing a fifteen percent increase in profits and an eighteen percent increase in sales over the previous year. Its profits and sales have risen continuously in the past five years, largely on the strength of aggressive marketing and the development of cheaper, more durable materials for the company's main product line.

The capacity of Essex's present facility has nearly been reached and its present market area has been thoroughly exploited. There is every reason to believe that an expansion of plant and market area would result in continued growth. Realizing the various problems and potentials inherent in their situation, the principals of Essex have seriously considered taking their company public. They have had preliminary discussions with a few investment banking concerns who are willing to underwrite an offering for their company, but they are also worried and perplexed as they ponder the time, expenses, and liabilities involved in a public offering of their securities. They wonder if there might not be a quicker, cheaper, and safer way to achieve the same goals that would result from a public offering of Essex's stock.

In the discussion which follows, we shall examine the goals Essex is seeking from an initial public offering of its securities and weigh the benefits and detriments of public financing against the other alternatives for raising capital. The alternatives to be considered will include debt financing, private and intrastate placements of securities, the "Regulation A" exemption, and various corporate combinations involving mergers or consolidations, including the so-called "instant public technique."

II. Public Offerings

A. *The Advantages of a Public Offering*

A public offering of securities has traditionally served several primary functions for both the company and its stockholders. First and foremost, it is a means for raising capital in substantial amounts from the public at large. Although the purposes for which the proceeds of the offering will be used vary from case to case, broad public support for a venture is usually dependent on the proceeds being earmarked for an expansion or diversification of the company's business. Consequently, thc primary purpose of an initial public offering of securities is generally to raise substantial amounts of equity capital for the corporation's use in the expansion and betterment of its business.

With this capital on hand, the corporation is given a new outlook on corporate life. It is no longer solely dependent upon the mortgage loan market for its capital needs or the banking community for its working capital needs. With money in its pocket, a corporation, such as Essex, is in a position to concentrate all its resources on the development and improvement of its business.

Depending on the capital needs of Essex, its stockholders may also recoup part of their original investments in the company by including part of their shares in the offering. This is accomplished by a "secondary offering" of some of their holdings, together with the stock of the company being sold. Such a combination will result in a considerable savings of time, effort, and expense over the separate transactions or series of transactions that would otherwise be necessary. Thus, through this combined offering, both Essex and its stockholders can obtain liquid funds while the company can retain the key personnel who have been responsible for its success.

Once the offering is completed, Essex has a marketable commodity in its own stock, which has attained a readily ascertainable market value. As a result, Essex can seek to expand its business by using either its newly-marketable stock or the cash it has obtained in the public offering for acquisition purposes. Thus, Essex has become considerably more flexible as to the direction in which it may move.

As a public company, Essex will be in a better position to attract and retain highly qualified, key personnel, both on the strength of its more widely established financial and business reputation and also on its ability to offer a compensation package that includes definitively valued securities. Whether the compensation package entails a deferred compensation plan (pension or profit-sharing), a stock option or stock purchase plan, or outright compensation in securities, the key factor from the employee's standpoint will be the opportunity to share in the growth and success of the company through the ownership of an equity interest in the company.

With additional equity capital Essex will also find it easier to borrow money through debt securities, mortgage and bank loans, and lines of credit. Thus, its working capital situation, both short-term and long-term, may be materially enhanced.

Many of the advantages sought by Essex in going public are paralleled by similar advantages to its major shareholders. As holders of a marketable security with a readily ascertainable value, the shareholders are in a better position to sell or pledge their shares than are the shareholders in a closely held corporation. Moreover, once their investment in the company is converted from private to public securities, the value of their investment may be more easily and certainly established for federal estate tax purposes.

There are less obvious advantages of being public that Essex's management and stockholders should not overlook. For example, once a company has become publicly held, its prestige among its competitors, customers, and the business community at large is generally heightened. Because there is a public market in its securities, there is a continuing interest on the part of the business community in the affairs and achievements of the company. Similarly, the standards that all public companies must meet instill greater confidence and trust in the company on the part of the people who deal with it. The mere fact that its name and the details of its business are published throughout the business community will result in Essex's developing a greater range of contacts throughout that community.

The investment banking firm that manages the first public offering for Essex will also have a stake in its business and market success. As a result, this investment banking firm will make a continuing effort to "sell" the company and to promote its growth. In addition, the company's association with its own investment banker may open up new vistas of sophisticated corporate finance and expansion that Essex and its management do not have the experience or time to develop for themselves.

In summary, a public offering permits Essex and its shareholders to raise more funds than can be obtained in any other manner; to establish the widest possible public market for the Essex stock; and to provide the company and its shareholders with the maximum possible flexibility as to their future.

B. *The Disadvantages of a Public Offering*

There are essentially four items to be considered as disadvantages in going public. These are as follows: (1) the initial liabilities and responsibilities of being a publicly held company; (2) the expenses involved in a public offering; (3) the continuing record-keeping and reporting responsibilities of a publicly held company; and (4) the dilution of its equity and loss of its corporate privacy. Since each of these is basically unrelated to the others, they will be discussed separately.

1. *Initial Liabilities.*—As noted in the Introduction, there are potential liabilities for those persons who participate in a public offering on behalf of a company. These liabilities are imposed by the Securities Act of 1933[4] and are both civil and criminal in nature.

The Act's civil liability provisions are sections 11, 12(1), and 12(2). Section 11 deals with liability for material misstatements or omissions in a registration statement. Section 12(1) deals with liability for offers or sales of unregistered securities which are required to be registered under the Act. Section 12(2)[5] deals with liability for material misstatements or omissions in connection with offers, or sales of any securities, whether registered, unregistered or exempted from the registration provisions of the Act.[6]

The Act's anti-fraud provisions are contained in section 17. Under this section, it is made illegal to engage in any activity or employ any device or scheme to defraud a purchaser of securities. This section applies to all securities and to all transactions that meet the basic

4. 15 U.S.C. §§ 77a-aa (1964) [hereinafter cited as the 1933 Act, employing the section numbers of the original public act].

5. 1933 Act § 12(2) provides: "Any person who—(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon tender of such security, or for damages if he no longer owns the security."

6. Although § 12(2) does not mention the exempt transactions of § 4, that section itself specifically exempts those transactions only from the requirements of registration. The one relatively unimportant exception in § 12(2) is for securities of governments and banks exempted by § 3(a)(2). Section 3(a) exempts the securities named therein from all provisions of the Act, unless otherwise expressly provided elsewhere in the Act.

jurisdictional requirements of the 1933 Act. In this connection, all that is required to meet the jurisdictional requirements for the application of section 17 is the use of any means or instruments of transportation or communication in interstate commerce or use of the mails. A violation of this section may be remedied by a civil action,[7] by criminal proceedings,[8] or by an investigation by the SEC and the subsequent institution of injunction proceedings.[9]

Sections 12(2) and 17 have extremely broad application and their penalties are severe. They deal with all offers to sell securities within the jurisdiction of the 1933 Act; therefore, their impact cannot be avoided by seeking alternatives to a public offering. These sections require that great care be taken in offering securities for sale, but their restrictions are well-known, and they have not been the basis of the recent concern over the 1933 Act liabilities.

Section 12(1) is concerned directly with securities which must be registered, and its coverage is likewise obvious and well-known. It is similar to section 12(2), in that an action based on section 12(1) must be brought by the person who purchases directly from the violator.[10] The clear warning of this section is that, if one wishes to rely on an exemption from registration,[11] he had better be sure that he qualifies for it; there is always the possibility that a disappointed purchaser will challenge his decision in court. A well-timed and well-planned registration, therefore, is the only way to avoid section 12(1) liability. Any marginal use of an alternative procedure will carry the threat of liability, at least until the statute of limitations has run.[12]

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7. *See, e.g.*, Pfeffer v. Cressaty, 223 F. Supp. 756 (S.D.N.Y. 1963); Schamber v. Aaberg, 186 F. Supp. 52 (D. Colo. 1960); Osborn v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949).

8. 1933 Act § 24 provides: "Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both."

9. 1933 Act § 20(b) provides that whenever it appears to the Commission that a person is engaged or about to engage in acts in violation of the statute, it may bring an action in federal district court to enjoin such acts.

10. 1933 Act § 12(1) provides that: "Any person who—(1) offers or sells a security in violation of section 5 . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

11. 1933 Act § 3 lists securities which are exempt from registration; § 4 exempts certain transactions from registration.

12. 1933 Act § 13 provides for the limitation of actions under §§ 11, 12(1) and 12(2). As

It is section 11 of the Act which has recently loomed large in the thinking of the securities bar, the financial community, and the business world. The touchstone for this widely discussed concern has been the case of *Escott v. BarChris Construction Corp.*[13] It is not the purpose of this article to analyze this case in depth,[14] but rather to assess its practical impact on a company's decision to make a public offering.

Under section 11, any person who acquires a security in connection with a registration statement containing an untrue statement of a material fact or a statement that is misleading because of the omission of a material fact may sue, among others, every person who signed the registration statement, every director of the issuer, every accountant who certified part of the statement, and every underwriter connected with the sale of the securities. In *BarChris*, an action under section 11 was brought against the issuer, its directors and principal executive officers, its controller, its underwriters, and its independent accountants. All were found liable for signing a registration statement which contained material misstatements and omissions of fact. In the course of its opinion, the court pointed out that, under section 11, the plaintiff need not prove that he relied on the false or misleading information or that the defendant knew of the misstatement or omission. The only defenses, according to the court, are that there was no material misstatement or omission or that the defendant exercised due diligence in determining the accuracy and completeness of the registration statement.[15] For reasons fully stated in its opinion, the court found that the registration statement contained several material misstatements and omissions and that the defendants did not exercise due diligence.

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to § 12(1) it provides that no action shall be maintained more than one year after the sale in violation of § 5, and in no event more than 3 years after the security was offered to the public.

13. 283 F. Supp. 643 (S.D.N.Y. 1968).

14. This case has been the subject of extensive comment and analysis. *See, e.g.* Proceedings, American Bar Association, Section of Corporation, Banking & Business Law, *The BarChris Case: Prospectus Liability*, 24 BUS. LAW 523 (1969); Wyant & Smith, *BarChris: A Revaluation of Prospectus Liability*, 3 GA. L. REV. 122 (1969); Note, *The Underwriter's Duty of "Due Diligence" Under Section 11 of the Securities Act: Reflections on BarChris*, 22 VAND. L. REV. 386 (1969).

15. Sections 11(b)(3)(A) and (C) set forth the 2 defenses of "due diligence" which apply to directors and officers of the issuer. Basically, these require a reasonable investigation and a reasonable ground for believing that the registration statement contains no false or misleading statements. In determining what is reasonable, the statute provides that "the standard of reasonableness shall be that required of a prudent man in the management of his property." 1933 Act § 11(c).

There is much in *BarChris* to arouse caution and doubt in the professional securities community concerning the preparation of registration statements. For Essex and those actually involved in its operations who must sign the registration statement, the following rules must be carefully followed: (1) Make every effort to determine the exact status of every aspect of the business, including future plans. (2) Give full and fair evaluations of each aspect of the business to the persons responsible for preparing the registration statement or any part thereof. (3) Answer completely and candidly all questions asked and volunteer any information which may be relevant to the questions asked, even though not directly called for. (4) In brief, be thorough, be careful, and be candid.

Each director and officer of Essex should read each part of the registration statement. If there are parts he does not understand, he should have them clarified. Every director and officer, including "outside" directors, should keep as fully informed as possible about the company's operations, especially those described in the registration statement. They should bear in mind that the law requires the registration statement to be accurate as of the effective date, not merely as of the date that it was compiled.[16] Finally, at each reading of the registration statement and at each discussion of its contents, they should ask themselves whether, under any possible construction or under any conceivable circumstances, there has been any "material misstatement or omission."

Thus, *BarChris* simply compels Essex and its officer-directors to be thorough and truthful as to the information set forth in the registration statement. Certainly, this is not an unreasonable burden to impose upon them.

2. *The Expenses of Going Public.*—It will be expensive for Essex to go public. The direct costs, not including the underwriting discounts and commissions, of even a modest offering (up to five million dollars) will be measured in the tens of thousands of dollars. In addition, the underwriters' total compensation may be as much as fifteen percent of the offering, depending largely upon the extent of their commitment to dispose of the issue and the degree of risk associated with the securities themselves.

Among the more important items of direct costs are the legal fees—both the company's and the underwriters'—for preparing the registration statement and attending to a myriad of related details;

16. 1933 Act § 8.

accounting fees for the certified financial statements; costs of printing the registration statement, prospectuses and underwriting contracts; registration and blue sky fees; and the initial fees to a registrar or transfer agent. In addition, the underwriter may request that an independent survey of Essex be made, and the cost of this survey must be paid by the company. There may also be a "finder" who has brought the company and the underwriter together and whose fee for doing so may amount to perhaps two percent of the proceeds to the company after underwriters' commissions. These fees, however, are frequently included in the underwriters' commissions.

There will also be a substantial indirect cost to Essex in terms of executive time, disruption of normal business, suspension of certain corporate activities during the registration period, and rearrangement of the corporate structure and certain corporate affairs to conform to the standards necessary to take the company public. Company officials should expect to spend from four to six months in preparing for the offering; much time will be spent answering seemingly endless questions and producing and analyzing countless documents. Moreover, they must continue to run the day-to-day affairs of the company with the added burden of maintaining and, in some cases, rearranging its affairs to meet the specifications described in the company's prospectus. In many instances, plans for extraordinary corporate activities of Essex will have to be suspended during the offering; such activities might affect the carefully worded descriptions of the company's business, its future plans, and its financial position as reflected in the registration statement.

One area of concern to Essex will be the formalization of certain corporate transactions and relationships with major suppliers, customers, and corporate insiders. This may call for the repayment of loans from the company to the insiders, or vice versa, the execution of leases, contracts, bills of sale to cover certain business transactions, and the execution of employment agreements with important executives.[17]

The extent to which these costs will inhibit a company such as Essex from going public will ultimately depend on whether a public offering is otherwise desirable. These costs, although substantial, are geared closely to the same forces which increase the economic benefits of going public and, therefore, may be considered a constant factor.

17. For a consideration of the tax consequences of these problems, see Appert, *Unwinding or Formalizing Non-Arms-Length Transactions Between Affiliated Taxpayers*, N.Y.U. 21st Inst. on Fed. Tax. 1353 (1963).

3. *Continuing Liabilities, Duties, and Costs.*—Once Essex becomes publicly held there are certain continuing liabilities and expenses that it must incur that would not be necessary if it continued as a closely held company. Once its registration statement filed under the 1933 Act becomes effective, it is required to file reports with the Securities and Exchange Commission pursuant to section 15(d) of the Securities Exchange Act of 1934.[18] These reports include the annual 10K report that must contain the certified financial statements of the issuer for the year to which the report relates; the 9K report, which is a semi-annual report on the financial status of the company; and the 8K report, which must be filed at the end of any month in which certain enumerated transactions take place. As the result of the Special Disclosure Policy Study Report submitted to the Securities and Exchange Commission in March, 1969, and the Commission's recent proposed revisions of these reports,[19] Essex should expect that its disclosure and reporting requirements, as a public company, will be expanded substantially in the near future.

In addition to these required reports, Essex will be obligated either by its underwriting agreements or by choice to mail financial statements to its shareholders on an annual, semi-annual, or quarterly basis. Its management will also be faced for the first time with the obligation to submit their continued service in the company to a vote of all of the shareholders when the time arrives to elect a new board of directors. If the company becomes listed on a stock exchange or reaches the stage where it has a million dollars in assets and over 500 shareholders, it has the obligation formally to register under the Securities Exchange Act of 1934.[20] This registration subjects the company for the first time to the SEC's proxy rules[21] and subjects its "insiders" to the reporting requirements of section 16(a) and the short-swing profits proscription of section 16(b) of the 1934 Act.[22] In

18. 15 U.S.C. §§ 78a-jj (1964) [hereinafter cited as 1934 Act, employing the section numbers of the original public act].

19. SEC Exchange Act Release No. 8683 (Sept. 15, 1969); SEC Exchange Act Release No. 8682 (Sept. 15, 1969).

20. 1934 Act §§ 12(a) & (g).

21. Section 14(a) of the 1934 Act provides that any proxy solicited in connection with a security registered under the 1934 Act must contain the information prescribed in the rules enacted by the Commission pursuant to this section. For the information required, see Rule 14(a)(1) - (12), 17 C.F.R. § 240.14(a)(1)-(12) (1969).

22. Section 16(a) of the 1934 Act requires each officer and director of a company with an equity security registered under § 12 of the 1934 Act, as well as each beneficial owner of more than 10% of such a security, to file a report with the SEC as to his holdings of all the company's

addition, the company must remember its responsibilities under Section 10(b) of the 1934 Act[23] and Rule 10(b)-5[24] thereunder as to corporate disclosure—the prompt and accurate disclosure of significant events in its business which could affect the market value of its stock. The *Texas Gulf Sulphur*[25] case is an example of the potential liabilities under these provisions. These various duties and statutory liabilities will result in additional expenses for Essex that were never a concern of the company when privately held.

4. *Dilution of Equity and Loss of Corporate Privacy.*—Concomitant with these increased corporate duties and the continuing liabilities, another unattractive feature of becoming a public company is the loss of identity between the original shareholders and Essex. Going public means that they own less of the company and that their continued control rests in part on the concurrence of the public shareholders. Their continuing duties to the shareholders and to the investing public entail a loss of corporate and, for the controlling individuals, personal privacy. These factors and their impact on the management of the company are very difficult to assess while the company is privately held and call for psychological adjustments on the part of key personnel—the company is no longer "mine" or "ours". There are new routines to be established, new risks to be considered. In all of these, the interests of the public shareholders of Essex must

equity securities and also to file a further report within 10 days after the end of any month in which there has been any ehange in his holdings.

Section 16(b) provides that any profits realized by an officer, director or over-10% shareholder of a company with an equity security registered under Section 12 from any purchase and sale, or sale and purchase, of the company's equity securities within any 6-month period may be recovered by the company. Suit for such a recovery may be brought by the company or by one of its shareholders if the company fails to bring suit.

23. 1934 Act § 10(b) provides that: "It shall be unlawful for any person, directly or indireetly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

24. Rule 10(b)-5, 17 C.F.R. § 240.10b-5 (1969), provides that: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in conneetion with the purchase or sale of any security."

25. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

be considered. Thus management must learn to accept the opinions and advice of outside directors without characterizing them as "interference."

The dilution of the shareholders' equity in Essex must also be measured in terms of a decreased share in the growth of the company, perhaps not in absolute terms, but certainly as a percentage of the whole. Moreover, management will undoubtedly want to share some of this growth with the public shareholders through dividend distributions. The SEC requires, however, that the prospectus limit the expectations of prospective shareholders in this respect.[26]

These are the major disadvantages to Essex and its shareholders of a public offering of its stock. Against these management must weigh the advantages of going public and make a decision. Before deciding this question, however, management should be aware of the alternative ways in which Essex can raise money. A comparison of the attributes of these alternatives with the attributes of going public will more clearly define the proper course of action.

III. Alternatives to a Public Offering

A. *Debt Financing*

It should be emphasized that under normal circumstances a company like Essex should defer a public offering of its stock until it has exhausted its borrowing capabilities. It should use borrowed funds as long as possible in an effort to build up its earnings per share. The increased earnings per share will enhance the desirability of the company's stock and the price it can command when it does become necessary for the company to go to the public for equity financing. Debt financing, therefore, is a most attractive alternative and should normally be used by a company if it can raise the amount of money needed.

The problem, however, is that the debt market in general is tight, and it is particularly tight for closely held companies such as Essex. Consequently, Essex will find it extremely difficult to raise substantial sums of money by debt financing. Thus, unless Essex needs only a small amount of capital, a public offering may be the next step for the company to take.

B. *Private Placements*

A private placement involves the sale of a block of securities to a

26. *See Guides for Preparation and Filing of Registration Statements*, No. 26, SEC Securities Act Release No. 4936 (Dec. 9, 1968).

few well-chosen private investors. In the typical situation, the purchasers are sophisticated investors who are reasonably well-informed as to the affairs of the company. As a private placement, the offering of the securities is exempt from registration under the 1933 Act.[27]

The principal advantages of a private placement to a company are speed and lack of expense. All the details of the placement can be handled by the company, its management, and its counsel. Whatever disclosures as to the company's business that are made can be limited to a relatively small group of persons who have a serious intention of purchasing the securities offered. The company avoids all registration and, following its offering, Essex will still be a private company.

From the viewpoint of Essex and its shareholders, the private placement involves both practical and legal difficulties. As to the practical problems, first, the shareholders must surrender part of their equity ownership in Essex, yet they will not obtain the benefit of a public market for the remainder of their stock. Secondly, in most instances the net price Essex will receive for its stock in a private placement will be less than the amount it would receive in a public offering. This is to be expected since the investor is unwilling to pay as much for the non-marketable security he receives in a private placement as he would pay for the marketable security he receives in a public offering. Thirdly, the private placement concentrates a substantial block of Essex's stock in the hands of a few people who are a potential threat to the present management. Lastly, many private placements require a voice in management for the private investors. If these management rights are substantial, they can seriously restrict the powers of existing management to carry out the objectives sought through the private placement.

The legal problems are generally involved. Essentially, they involve the following three questions: (1) the size of offering that can qualify as a private placement; (2) the intent that is necessary on the part of the purchaser to preserve the exemption; and (3) the extent that Essex can control the further sale of its stock once it is in the hands of the private investors.

The size of offering that can qualify as a private placement will depend upon the particular facts of each case. Thus the only certain way to proceed (if the transactions could in any way be questionable)

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27. 1933 Act § 4(2) provides that: "The provisions of section 5 shall not apply to . . . (2) transactions by an issuer not involving any public offering."

is to obtain a "no action" ruling from the Division of Corporate Finance of the SEC. In considering such requests, the Division will consider the following criteria: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of the offering.[28]

It should be emphasized that it is the number of offerees, not purchasers, that is considered under (1) above. Obviously, if a company is interested in establishing a wide market for its securities, this exemption becomes less applicable as the desired market grows larger. Similarly, the more remote an offeree is from the affairs of the company or its principals, the more likely it is that he will be deemed a member of the "public."

The number of units and the amount of the offering are likely to be in direct proportion to the number of offerees. If large quantities or large amounts of securities are offered to a few persons, it is likely those persons will be familiar enough with the operations of the company that the size and amount will be discounted. The reverse of this situation, however—a small number or amount of securities offered to a great number of people—is much less likely to qualify for a private exemption. In summary, the securities laws are designed to protect the public at large. Consequently, if the securities are offered to people who are not well-informed as to the affairs of the company, it is unlikely that the private placement exemption will apply.

The intent that is necessary on the part of the investor to preserve the exemption is well established. If the intention of the investor in buying the securities is not "investment," but "distribution," the exemption is lost. Prior to the decision of the SEC in *The Crowell-Collier Publishing Company* case,[29] it was assumed that a company could protect itself by requiring the purchaser to give a written affirmation of his intent to hold for investment. This was known as the "investment letter." *The Crowell-Collier* case held, however, that the private placement exemption could not be gained by the mere "formality of obtaining investment representations."[30] Thus to protect itself Essex should place transfer restrictions directly on the face of the stock certificates sold in any private placement.

Finally, the law requires a "change of circumstances" before a purchaser of investment securities can resell them. This raises the

28. SEC Securities Act Release No. 285 (Jan. 24, 1935); SEC Securities Act Release No. 4552 (Nov. 6, 1962).

29. SEC Securities Act Release No. 3825 (Aug. 12, 1957).

30. *Id.*

question of what circumstances are relevant and to what extent circumstances must change. The answers to these questions will depend largely on each individual case. It is safe to say that the mere passage of time will not establish a conclusive presumption of a change in circumstances, but the investment community seems to agree that holding for two to three years provides at least the basis of a reasonable margin of safety for those purchasers desiring to sell their securities. In an attempt to remedy the uncertainty presently attending the resale of privately placed securities, the Commission has proposed sweeping rule changes.[31] First, there is a new, objective definition of the term "distribution" which would apply to the resale of securities purchased in private offerings. If the securities involved are those of a company currently reporting its affairs to the SEC under sections 13 or 15(d) of the 1934 Act, they may be resold to the public one year after purchase, provided the sale is not too large to be absorbed into the market and, provided further, that no extraordinary commissions are required to sell the securities. The criteria for meeting the provisos are basically those of the present Rule 154,[32] with certain modifications.

If the issuer is not a "reporting company," the securities it places privately are "restricted securities." Under the new proposals, such securities would have to be held at least five years before they could be resold to the public without registration. The SEC might prescribe a longer period if it considers it necessary for investor protection. Thus, "investment intent" and "change of circumstances" become irrelevant.

These new proposals obviously put a premium on compliance with the reporting requirements of the 1934 Act. Although a company may voluntarily register to file such reports, even though not required to do so, one result of the new proposals, if accepted, would undoubtedly be to increase the attractiveness of going public.

The above discussion should make it clear that Essex, in making a private placement of its securities, does so at some risk and inconvenience to itself. Moreover, these detriments increase as it attempts to enlarge its offering. Unless it has limited capital requirements or unless an institutional investor or a small number of informed individual investors can be found, this exemption from registration will probably not serve the general goals usually associated with going public.

31. SEC Securities Act Release No. 4997 (Sept. 15, 1969).

32. 17 C.F.R. § 230. 154 (rev. ed. 1969).

C. *The Intrastate Exemption*

If the management of Essex feels that its goals would not be served by a private placement of its securities, the sale of its securities exclusively to those resident in the state of its incorporation and principal place of business may be considered.

The 1933 Act exempts from registration "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."[33] The SEC has stated:

> The legislative history of the Securities Act clearly shows that this exemption was designed to apply only to local financing that may be practically consummated in its entirety within the State or Territory in which the issuer is both incorporated and doing business.[34]

The intrastate offering is reasonably inexpensive and quick. It is in a sense, however, a "public" offering in that the securities may be offered to large numbers of people who have no previous relationship to the issuer. Therefore, there is more likely to be an offering circular and other sales literature distributed in connection with the sale. The exemption is not lost by the use of the mails or other instruments of interstate commerce so long as the solicitation makes it absolutely clear that the securities are being offered and will be sold only to residents of the particular state involved.

Again, there are practical and legal limitations on the ability of a company like Essex to raise capital under this exemption. Obviously, the primary disadvantage is the practical limitation on the amount of funds a company can raise in a single state. Unless the amount that can be raised meets the company's needs, it must seek another route to meet its capital requirements. Secondly, the company must verify the residence of each purchaser of its stock in an intrastate transaction.[35] If any stock is sold to a non-resident, this exemption will be lost. Thirdly, the company must be incorporated and doing a substantial portion of its business in the state in which the offering takes place.[36] Fourthly, the offering cannot be a part of a larger financing plan involving a past, present, or future interstate sale of securities. If it is,

33. 1933 Act § 3(a)(11).

34. SEC Securities Act Release No. 4434 (Dec. 6, 1961).

35. SEC Securities Act Release No. 4434 specifies that for the purposes of the exemption "residence" means "domicile."

36. *Id. See also* SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957).

all the offerings will be integrated and the intrastate exemption will not apply to any part of the transaction.[37] Finally, and most importantly, the original offering may become disqualified subsequent to the offering by the later resale of these securities across state lines.[38]

Thus, a successful intrastate offering requires not only a sizable original market but also a sufficient local interest to maintain a viable after-market within the state. A company such as Essex will have substantial practical problems in attaining these market conditions except possibly with respect to a very small issue. Moreover, because of the threat of integration, use of the exemption could actually harm a company's long-range financing programs.

D. *Regulation A*

If the capital needs of Essex are not substantial, it might consider taking advantage of a rather simple procedure under the 1933 Act to raise a quick 300,000 dollars. Regulation A,[39] promulgated pursuant to section 3(b) of the 1933 Act,[40] provides a procedure whereby interstate public offerings of not more than 300,000 dollars in any one year may be made without registering the securities. As with other exemptions, the burden of proving its availability is on the company, but unlike the others, a Regulation A exemption requires affirmative action with the SEC before an offering may be made. The company must prepare and file with a Regional Office of the SEC all the required information that enables the SEC to determine the availability of the exemption. An offering circular containing certain required information about the company, its financial situation and the offering itself must also be

37. SEC Securities Act Release No. 4434 provides in part: "Any one or more of the following factors may be determinative of the question of integration: (1) [a]re the offerings part of a single plan of financing; (2) do the offerings involve issuance of the same class of security; (3) are the offerings made at or about the same time; (4) is the same type of consideration to be received, and (5) are the offerings made for the same general purpose."

38. How long one must safely wait to sell so that his sale is not deemed part of the distribution process is a matter of some debate. *See* H. SOWARDS, THE FEDERAL SECURITIES ACT § 3.12[6][b] (1963); Wander, Book Review, 23 BUS. LAW. 1237, 1238-39 (1968). The view which cautions a wait long enough to raise at least a presumption of a "change in circumstances" seems the most sound.

39. 17 C.F.R. §§ 230.251-.263 (rev. ed. 1969).

40. 1933 Act § 3(b): "The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $300,000."

filed with the SEC and distributed to each purchaser in the offering. Secondary offerings by insiders may amount to as much as 100,000 dollars of the yearly total.

The principal advantage of the Regulation A offering is that it can be handled more expeditiously and at less cost than a public offering. Although an offering circular must be used in connection with such an offering, the information required is substantially less than that required to be contained in a prospectus used in connection with a public offering.

The disadvantage of the Regulation A offering is, of course, the small amount of capital that a company can raise through it. Undoubtedly, for a medium-sized, growing company such as Essex the yearly limit of 300,000 dollars would be too restrictive to provide the capital necessary for sustained growth or to maintain the strong after-market necessary to continue the promotion of the company to the public.

E. *"Instant Public"*

The principal shareholders of Essex may want to consider using a technique, often called "instant public," that allows a company's securities to be publicly traded and, in effect, allows the company to become publicly held, without the registration of its securities under the 1933 Act. The technique involves combining a private company with a public company in such a way that the private company is the surviving company and is able to succeed to the latter company's public position. Essex's best use of this alternative might be to buy any one of the numerous "shell corporations,"[41] many with over 1,000 shareholders, offered for sale in the classified ads of the leading financial newspapers and periodicals and consider a combination resulting in the transfer of Essex's business to the shell. The advantages would be that trading in the stock of the "new Essex" would begin immediately and would pave the way for a later offering of its stock, perhaps at a much higher price. The stock of Essex owned by the principals would immediately have a determinable value, and the company might achieve some of the side advantages of a public company.

One of the major disadvantages of this technique is that, although the company becomes publicly held much quicker and cheaper than is possible through a registration, no capital is raised since there is no sale

41. The term "shell corporation" as used herein refers to a corporation with neither assets nor liabilities.

of its securities involved. The equity of the company, however, is immediately diluted. Hence a further offering will still be needed to raise capital for the company.

Another disadvantage of the "instant public" technique is the published position of the SEC concerning the legality of this technique under the Federal securities laws. In a recent release,[42] the Commission cited two examples and gave a stern warning to the public and to brokers and dealers that the use of these techniques could involve violations of the registration requirements of the 1933 Act and the anti-fraud and anti-manipulative provisions of both the 1933 and 1934 Acts.

The Commission's first example deals with an inactive private company that issues its shares to a publicly-owned company for nominal consideration. The public company subsequently spins these shares off to its shareholders with the result that active trading in the shares begins without any information on the new public company available to the investing public. In the release, the Commission takes the position that the sale by the private company of its shares to the public company is a "sale" within the meaning of the 1933 Act, and that, if the shares are subsequently spun off by the public company, it may be a statutory underwriter within section 2(11) of the 1933 Act. The Commission admits that while the initial spin off to the acquiring company's shareholders may not constitute a distribution for purposes of the 1933 Act, the entire process, including the redistribution of the securities in the trading market, which can certainly be anticipated and which may be the only purpose of the spin off, may have that effect. Moreover, subsequent transactions in these shares by dealers would be subject to section 5 of the 1933 Act requiring the delivery of a prospectus during the periods set forth in section 4(3) of the Act.[43]

In reaching its conclusion, the Commission noted that the theory is often advanced that since there is no actual sale involved in the distribution of the shares in the spin off, registration of the shares is not required, and that even if technically required, no purpose would be served thereby since the persons who receive the shares in the spin

42. SEC Securities Act Release No. 4982 (SEC Securities Exchange Act Release No. 8638) (July 2, 1969).

43. Section 4(3) exempts from the prospectus requirements of § 5 of the Act transactions executed by a dealer after the expiration of 40 days from the effective date of the registration statement involved, or from the date on which the securities were bona fide offered to the public, whichever date is later. In the case of securities which have not been previously sold pursuant to an earlier registration statement, the period is extended to 90 days. The corollary to this exemption is that the prospectus requirements of § 5 of the Act must be complied with during the applicable 40 or 90 day period. 1933 Act § 4(3).

off are not required to make an investment judgment. In dismissing this argument, the Commission stated:

> This reasoning fails, however, to take into account that there is a sale by the issuer and the distribution thereafter does not cease at the point of receipt by the initial distributees of the shares but continues into the trading market involving sales to the investing public at large. Moreover, it ignores what appears to be primarily the purpose of the spin off in numerous circumstances which is to create quickly, and without the disclosure required by registration, a trading market in the shares of the issuer. Devices 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.' In the circumstances of a spin off, when the shares are thereafter traded in the absence of information about the issuer, the potential for fraud and deceit is manifest.[44]

It does not appear that the Commission's legal conclusion would be changed even if the company whose securities were spun off were a profitable, active company like Essex, whose management would probably make a concerted effort after the initial distribution to disclose all pertinent information concerning its business affairs to the public. The fact would still remain that such a distribution involves the participation of a statutory underwriter. The Commission would therefore probably require that the shares distributed be registered under the Act.

Although it seems possible that an instant public technique designed to counter the Commission's legal objections could be devised by Essex, the basic disadvantages of the procedure cannot be avoided; the technique still fails to fulfill the primary purpose of a public offering—the raising of capital for the corporation. As a result, the various instant public procedures currently being used are not valid alternatives to a public offering since they are not financing techniques, but market techniques.

To illustrate this legal objection, the Commission cites the case in which promoters acquire the control of an inactive public shell with a view towards quickly increasing the market value of their shareholdings. Spurious assets are transferred to the corporation in exchange for substantial amounts of newly issued shares. The "acquisitions" of the corporation are highly publicized to stimulate interest in the shares of the company. After the market price is artificially inflated by these activities, the promoters dispose of their

44. SEC Securities Act Release No. 4982 (SEC Securities Exchange Act Release No. 8638) (July 2, 1969).

stock. It is obvious that the Commission feels that such a technique involves serious violations of the anti-fraud and anti-manipulative provisions of the 1934 Act and the registration provisions of the 1933 Act.

F. Disposition of the Company by Merger, Consolidation, or Sale

The complete disposition of a company by its controlling shareholders or its combination with another enterprise may at first seem remote from the primary goals of going public, almost all of which are centered around continued control of the business by the original owners. But many of those who begin by thinking of selling a portion of their company to the public end up by selling all of it to another corporation or group of interests. By so doing, they convert their ownership interest into cash or shares of a more diversified business. At the same time, management frequently remains in operating control of their former company in its new status as a subsidiary or division. Moreover, through use of stock of the acquiring corporation, this result can usually be accomplished tax-free at a small fraction of the cost of making a public offering. Of course, the single, foremost disadvantage of this course of action will be that the stockholders and management lose direct control and ownership of their company. Therefore this is not an attractive route for those who have an overriding desire to manage their own public company.

IV. Conclusion

Let us return to the executive suite of Essex Industries to see how the company's management have benefited from our discussion. The stated purposes of this discussion were (1) to examine the relative advantages and disadvantages of going public and (2) to compare these results with the results of other alternatives for raising capital.

As set forth in Section II, there are many substantial advantages that Essex can obtain from going public. In doing so, management subjects itself to new responsibilities and potential liabilities, but these can be endured if management is willing to exercise the care that corporate directors are expected to exercise. Substantial costs will be incurred in going public but these must be measured, not in absolute amounts, but in relation to the financial benefits derived by the company from a public offering of its securities. In summary, a successful public offering for Essex will result in its raising a substantial amount of equity capital which will enhance the continued expansion of the company and will provide a wide-spread, viable after-market for the continued promotion of the securities of the company.

None of the alternatives will permit the raising of as much capital for Essex as a successful public offering will provide. Moreover, none of them will provide for a strong after-market for the company's stock. The costs incurred in carrying out any of the alternatives will undoubtedly be less, but in relation to the benefits obtained, they will probably be disproportionately higher. As to liabilities, it seems that the legal problems of the alternatives are equally as hazardous as the public offering, particularly when the problems of compliance with the securities laws are considered.