



CSU
College of Law Library

Cleveland State Law Review

Volume 2 | Issue 1

Article

1953

Securities and the Small Corporation

Leonard Lane

Follow this and additional works at: <https://engagedscholarship.csuohio.edu/clevstlrev>



Part of the [Securities Law Commons](#)

[How does access to this work benefit you? Let us know!](#)

Recommended Citation

Leonard Lane, Securities and the Small Corporation, 2 Clev.-Marshall L. Rev. 93 (1953)

This Article is brought to you for free and open access by the Journals at EngagedScholarship@CSU. It has been accepted for inclusion in Cleveland State Law Review by an authorized editor of EngagedScholarship@CSU. For more information, please contact library.es@csuohio.edu.

Securities and the Small Corporation

by Leonard Lane*

IT IS NOT THE PURPOSE of this article to encompass in its entirety the vast field of securities transactions, but rather to examine this field from the position of the small corporation. Only the high points of this limited area are dealt with, and of necessity the treatment is not exhaustive. Wherever possible, an attempt will be made to point out the problems which might beset the small corporation which is not fully cognizant of the importance of state and federal securities legislation.

While it is true that the federal legislation was not enacted primarily for the small corporate issuer, its impact nevertheless is upon the small as well as the large. Thus, the small corporation, like any other issuer of securities, must concern itself with complying with both federal¹ and state legislation.²

The basic philosophy of the Federal Securities Act is "full disclosure"; that is, under the stringent provisions of registration,³ the issuer must give all details of the proposed issue which are necessary to enable the prospective purchaser to make an intelligent decision with regard to the worth of the particular security. After the issuer has satisfied these requirements, the duty of the Securities and Exchange Commission terminates. Thereafter, the prospective purchaser must make his own decision, since the S. E. C. will not pass judgment on the worth of the securities, and will not prevent an issuance of securities even where the terms of the issuance are manifestly unfair to the purchaser. Most state Blue Sky legislation, however, is concerned not only with *disclosure*, but with the *fairness* of the terms of the securities offering as well.

Two important concepts which underlie both the state and federal laws are "security" and "sale." Even upon cursory examination, it is apparent that the statutory definitions are more

* Mr. Lane, A. B., LL.B., is a graduate of the law school of Western Reserve University. He is a partner in the Cleveland, Ohio law firm of Mendelsohn, Lane and Traeger and a member of the Ohio and Federal Bars.

¹ Securities Act of 1933 and Securities and Exchange Act of 1934.

² Blue Sky Laws.

³ Sections 6 and 7 of Securities Act of 1933.

inclusive and broader than the commonly accepted meaning of the terms. "Security" is defined in Section 2 (1) of the Federal Securities Act of 1933;⁴ "Sale" is defined in Section 2 (3).⁵

The jurisdiction of federal legislation is found in Section 5 of the Federal Securities Act of 1933 which provides:

"(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

"(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or

"(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

"(b) It shall be unlawful for any person, directly or indirectly—

"(1) To make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security registered under this title, unless such prospectus meets the requirements of section 10; or

⁴"(1) The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." (For definition of term "security" under the Ohio Securities Act see footnote 15.)

⁵"(3) The term 'sale,' 'sell,' 'offer to sell,' or 'offer for sale' shall include every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value; except that such terms shall not include preliminary negotiations or agreements between an issuer and any underwriter. Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value. The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be a sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security." (For definition of term "security" under the Ohio Securities Act see footnote 15.)

"(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of section 10."

FEDERAL EXEMPTIONS.

The major problem of the small corporation is that of determining whether or not it is entitled to one or more exemptions provided for in the Act. Although a securities issue may be "exempt," it is important to understand that it is exempt only from the registration requirements and is still very much subject to the fraud and civil liability provisions of the Act.⁶

There are several types of exemption provisions in the Securities Act of 1933 and there are three types which provide the method most generally used by the small corporate issuer. The latter are: (1) that the offering is a private one;⁷ (2) that the issue does not exceed the sum of \$300,000;⁸ and (3) that the offering is wholly intrastate.⁹

Private Offering Exemption.

Section 4 (1) of the Securities Act of 1933 exempts "transactions by an issuer not involving any public offering." While this exemption is not as frequently used as others by the average small corporation, it is significant enough to warrant comment on certain of its aspects. First, there is no magic number which determines whether an issuance is or is not a public offering. Generally, by a very rough rule of thumb, if the number of offerees does not exceed twenty-five, the issuance can almost always be considered as a private offering.¹⁰ However, it is most important to understand that it is the number of *offerees*, not the number of *purchasers* of the issue of securities which is determinative.

For example, let us examine the case of a typical small corporation. The articles of incorporation or corporate charter of

⁶ Sections 12 and 17, Securities Act of 1933.

⁷ Section 4 (1), Securities Act of 1933.

⁸ Section 3 (b), Securities Act of 1933.

⁹ Section 3 (a), Securities Act of 1933.

¹⁰ However, in *S. E. C. v. Ralston Purina Co.*, the U. S. Court of Appeals, 8th District, on November 21, 1952, upheld the District Court's holding that a company's offering of common stock to an estimated five to six hundred "key employees" was a "private" offering.

Corporation X authorize the issuance of 250 shares of no par common stock whose price is fixed in accordance with the law of the particular state at \$10 per share. Let us assume further that the securities are offered to 100 persons but are finally sold to only 25 persons. This transaction will probably not be exempt under Section 4 (1) of the Act because the number of offerees was 100, even though the number of purchasers was only 25. Although this transaction might be entitled to another kind of exemption, Corporation X will be in error and subject to the penalties of the Securities Act of 1933, if it assumes that this particular offering does not constitute a public offering.

If Corporation X has complied with the law by offering to only 25 persons, it must still face the additional problem of being certain that those persons who purchased, did so for purposes other than for re-sale. The rationale of this requirement is obvious if one realizes that a complete subterfuge might be practiced if the subscribers would immediately split their stock and re-sell it to others. If a complete split were effectuated, (other than fractionally) there could possibly be 250 stockholders and the offering most certainly would be a public one.

How may a corporation which can be held liable if such immediate re-sale occurs, protect itself against the eventuality of such action on the part of its initial subscribers? This question, of course, involves the intention of the purchaser, which intention being somewhat subjective, is most difficult to ascertain. To fortify its position, it is recommended that Corporation X obtain from all original subscribers a signed statement reading as follows:

"I am purchasing (or subscribing to) ----- shares of stock of the X Corporation for purposes other than re-sale."

However, such a signed statement obtained by the corporation is by no means a cure-all or a complete defense. If it constitutes a part of a scheme participated in by the corporation to circumvent the provisions of the Act, it will fail; but if the corporation is acting in good faith, it will be helpful to have such statements in its files in the event that any of the stock is quickly re-sold.

Generally, if none of the stock is re-sold for at least one year after its initial issuance, the transaction will not be questioned unless it is part of a scheme of general distribution.¹¹

¹¹ Securities Act Release 1862 (1938).

The occupation of the subscribers is also important in determining whether or not the exemption is available. For example, if even one of the purchasers of the stock of Corporation X is a dealer in securities, it might be assumed that the securities were not taken for investment but for the purpose of re-sale.

Intrastate Offering.

An intrastate security offering exemption is a method of financing often used by the small corporation. Let us suppose that Corporation X is not interested in obtaining a private offering exemption but wishes to make a public offering which will be entirely intrastate, and to take advantage of the exemption provisions of Section 3 (a) (11) of the Act. This section provides:

“(11) Any security which is a part of an issue 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.”

When Corporation X engages in such a securities issuance there are certain definite principles which must be established and carefully complied with, or the exemption might be lost. The S. E. C. must be satisfied that: (1) the corporation is incorporated in the state of the securities issuance; (2) the corporation does business in the state of the security issuance; (3) the securities are offered to residents of the state in which the corporation is incorporated and does business; and (4) the purchasers must acquire the stock for purposes other than re-sale to non-residents of that particular state.

The requirements of incorporation in the state of issuance is usually a simple matter if Corporation X is acting in good faith. However, if Corporation X is a dummy corporation in the particular state and other corporations have been organized in other states in order to circumvent the act by effectuating what would amount to a nation-wide securities issuance not registered because of supposed compliance with this section, such a plan will fail and the corporation will be subject to the penalties of the Act.

Corporation X must avoid the offering of such securities to non-residents even if no non-residents are purchasers. As a consequence of the broad definition of “sale” in the act, such an offer would undoubtedly destroy the exemption under this section.

As we have seen in Section 4 (1), it is not just the initial sale of the securities which is determinative of whether or not the exemption is available, but equally determinative is the final resting place of the securities.¹² The case of *Brooklyn Manhattan Transit Corp.*¹³ involved an issuance of \$8,000,000 in securities which was sold to underwriting houses in New York State. About 15% found their way to non-residents and it was held that this fact destroyed the exemption under Section 3 (a) (11) even though the initial purchasers (underwriting houses) were residents of the State of New York.

Again the intention of the purchaser becomes important. Corporation X should obtain a signed statement similar to the one recommended in the discussion of Section 4 (1), but altered to read somewhat as follows:

"I am a resident of the State of _____ and am purchasing _____ shares of stock for purposes other than re-sale to non-residents."

In Securities Act Release No. 1459, the General Counsel of the Securities & Exchange Commission said:

"... In conclusion, I should like to stress once again the fact that Section 3 (a) (11) is designed to apply only to such types of distribution as are genuinely local in character. From a practical point of view, the provisions of that section can exempt only issues which in reality represent local financing by local industries, carried out with purely local purchasers. In distributions not of this type, the requirements of Section 3 (a) (11) will be extremely difficult if not impossible to fulfill. . ."

Small Issues.

Under Section 3 (b) of the Act, a corporation may issue securities not in excess of \$300,000 regardless of the residence of the purchasers or the number of offerees, and still be entitled to an exemption. This exemption is available every twelve months. To obtain the benefits of this exemption, Corporation X must file under Regulation A, a letter of notification stating certain basic, but not overly detailed, information about the corporation, its officers, and the proposed issue. Securities may not be offered for sale until ten days after the filing of such a

¹² Securities Act Release No. 20.

¹³ 1 S. E. C. 147 (1935).

letter with the S. E. C. Regulation A also requires that an offering circular containing certain minimum information, including financial information, be filed with the Commission. If there is to be any literature distributed or radio broadcasts made concerning the securities, three copies must be filed with the S. E. C. five days before its use. This exemption is also binding upon the affiliates or controlling persons of the corporation, and if such affiliates use any portion of the exemption, Corporation A can issue proportionately less securities.

BLUE SKY LAWS (OHIO).

The Ohio Division of Securities exercises supervisory control over all securities sold in Ohio. It is, of course, true that the Ohio Securities Act regulates only the sale of securities in Ohio.¹⁴

Corporation X, having decided for which exemption it can qualify, is now free to issue its securities. Although the philosophy of the Federal Securities Act is "full disclosure" and the S. E. C. will never pass upon the merits of the securities, Corporation X must comply with the registration requirements of the particular Blue Sky Law of the state in which the issuance is to be made, a law which is frequently concerned with the merits of securities.

Because most phases of the Blue Sky Law are important to the small corporate issuer, the most commonly used sections will be considered in some detail. The Blue Sky Law of the State of Ohio will be used as an example of state legislation, for Ohio is in most respects similar to the legislation of the other states. Therefore all code sections referred to will be sections of the General Code of Ohio.

Since the Blue Sky Law also deals with the regulation of "security," this term is defined in Section 8624-2 (2).¹⁵ Compared with the definition in the Federal Securities Act of 1933 it

¹⁴ Administrative Ruling 12, Ohio Division of Securities.

¹⁵ "(a) The term 'security' shall mean any certificate or instrument which represents title to or interest in, or is secured by any lien or charge upon, the capital, assets, profits, property or credit of any person (as that term is defined by subsection (4) of this section 2) or of any public or governmental body, subdivision or agency, and shall include shares of stock, certificates for shares of stock, voting trust certificates, warrants and options to purchase securities, subscription rights, interim receipts, interim certificates, promissory notes, all forms of commercial paper, evidences of indebtedness, bonds, debentures, land trust certificates, fee certificates, lease-

is, although longer than the federal definition, probably no more inclusive except in that portion which makes real estate situated outside of the State of Ohio, or an interest therein, a security, a provision which will be considered later.

In the case of *State v. Weger*,¹⁶ it was held that a person who issues or authorizes the issuance of promissory notes, signed in blank and numbered in a series, ostensibly entitling the purchaser to a certain proportionate share in the enterprise when it reaches completion or is productive of profit, is in effect selling securities and not just borrowing money. The agent of the issuer in this case was authorized to issue the notes to "anybody that came in and put their money down for them." The defendant contended that the issuance of such promissory notes is exempt from registration by virtue of Section 8624-3 (6), which is a securities exemption and exempts commercial paper and promissory notes from the registration of the Act when such notes are not "offered directly or indirectly for sale to the public." This defense was held to be untenable by the court in light of the circumstances of the offer.

A scheme whereby a person sold parking meters and vending machines and received from the purchaser a lease agreement which allowed the purchaser to share in the gross proceeds has been held to constitute a sale of securities.¹⁷

The definition of "sale" which is found in Section 8624-2 (3) is also similar to the federal definition.¹⁸

Exempt Securities.

Section 8624-3, which is comparable to Section 3 of the Federal Securities Act of 1933, deals with securities which are exempt

hold certificates, syndicate certificates, endowment certificates, certificates or written instruments in or under profit sharing or participation agreements, or in or under oil, gas or mining leases, or certificates or written instruments of any interest in or under the same, receipts evidencing reorganization or reorganization subscriptions, preorganization certificates, reorganization certificates, certificates evidencing an interest in any trust or pretended trust, any investment contract, any instrument evidencing a promise or an agreement to pay money, and the currency of any government other than that of the United States and Canada, but the provisions of this act shall not apply to bond investment companies or to the sale of real estate.

"The term 'security' shall, for the purposes of this act, be deemed to include real estate not situated in this state and any interest in real estate not situated in this state."

¹⁶ 25 Ohio L. Abs. 49 (1937).

¹⁷ Attorney General Opinions 891, June 8, 1939.

¹⁸ See footnote 5.

in and of themselves. These securities are either guaranteed or issued by such relatively secure organizations that there usually is no necessity for additional investigation and examination by the Division of Securities. Some of these securities are (1) securities issued or guaranteed by the United States Government; (2) securities issued or guaranteed by a corporation or government agency of the United States or Canada; (3) securities issued or guaranteed by a bank; (4) securities which are listed on one of the principal stock exchanges; (5) securities of certain public utilities; (6) commercial paper or promissory notes not offered for sale to the general public; (7) securities issued or guaranteed by insurance companies; (8) securities of non-profit organizations; (9) securities outstanding for no less than five years in which there has been no default in either principal, interest or dividend payments for five years before the sale.

Transaction Exemptions.

Section 8624-4 exempts certain securities transactions—as distinguished from Section 8624-3 in which the securities themselves are exempt.¹⁹ The transactions which are exempt are usually those over which sufficient supervision has already been exercised, and those which need no additional investigation for the protection of the purchaser of securities.

Section 8624-4 (1) exempts the sale of securities by or on behalf of a bona fide owner, not the issuer thereof or a dealer, when the sale is made in good faith and is not made for the purpose of avoiding the provisions of the Blue Sky Law.

If two domestic corporations are to be consolidated under the General Corporation Act of Ohio and the resultant corporation will issue its securities to the shareholders of the constituent corporation in exchange for the securities of such corporation held by such shareholders, it has been decided by the Division of Securities that such a transaction is exempt under Section 8624-4 (10), and such ruling would not be affected if one of the corporations is a foreign corporation; nor would the ruling be different if a merger rather than a consolidation is effectuated.²⁰ However, a plan of corporate reorganization providing for

¹⁹ These two sections are comparable to the federal legislation where Section 3 of the Securities Act of 1933 includes securities which are exempt and Sections 4 and 2 contain the securities transactions which are exempt.

²⁰ Administrative Ruling 3, Ohio Division of Securities.

the issuance of new first preferred shares of the corporation in exchange for bonds of another corporation, is not exempted under Section 8624-4 (10).²¹

It has been held, however, that if Corporation A owns shares of Corporation B and proposes to distribute such shares as a dividend to the shareholders of Corporation A, such transaction is exempt under Section 8624-4 (10).²² That section also grants a transaction exemption, in effect, for share dividends or for the exchange of any securities by the issuer with its existing security holders when no commission or remuneration is paid or given.

Section 8624-4 (13) is exceedingly important to the small corporation, for it is the vehicle under which most close corporations can be capitalized. It grants a transaction exemption to the *initial* sale of voting shares by a corporation where the total number of shareholders after such sale does not exceed five. Within sixty days thereafter, the issuer must file a notification of such issuance on Form 4-13 which is provided by the Division of Securities. This procedure is relatively simple. However, one error which is frequently committed by the corporation which has qualified for a "4-13 exemption," is the issuance of *additional* securities without further registration with the Division of Securities. For example, a corporation is authorized by its corporate charter or articles to issue 250 shares of no par common stock. Initially 100 shares are subscribed and paid for by two persons, and the corporation files a transaction exemption notification in accordance with Section 8624-4 (13). One year later the corporation, having 150 shares of stock authorized but unissued, issues 50 shares of stock to each of two new persons. This issuance, unless registered, is in violation of the Ohio Blue Sky Law, even though the total number of subscribers still remains under five, since Section 8623-4 (13) specifically provides that the exemption applies only to the *initial* sale. Therefore, the corporation must register these additional securities either by description or by qualification, unless they are exempt for some reason under the provisions of Section 8624-3.

Reorganization.

Section 8624-4 (a) grants to the Division of Securities the power to conduct hearings and to consider plans of reorganiza-

²¹ Administrative Ruling 4, Ohio Division of Securities.

²² Administrative Ruling 5, Ohio Division of Securities.

tion or of recapitalization. These plans, which may be submitted to the Division by the corporation or by its stockholders or creditors, must contemplate the issuance of securities in exchange for securities outstanding, or partially in exchange for securities outstanding. The acceptance of this plan by the Division makes any further registration unnecessary.

Registration by Description.

Section 8624-6 (1) provides for registration by description;²³ and in this connection intangible property is defined in Section 8624-2 (12).²⁴

The requirement that the commission or expense in connection with the sale not exceed three per cent, insures the purchaser that substantially all of the money from the sale of the securities will inure to the benefit of the corporation. Since three per cent is the maximum commission paid, a purchaser may assume that the security is a substantial one, because no underwriting house would handle a doubtful stock even on a "best efforts" basis for three per cent or less.

Assume that a corporation wishes to issue securities for intangibles, and to take advantage of registration by description, as provided in Section 8624-6 (1). To accomplish this end, the corporation would first take advantage of the transaction exemption provision of Section 8623-4 (13) and initially issue securities to less than five persons, some of the securities being issued for intangible property. Desiring to add more stockholders, the corporation would then file a new registration under Section 8624-6 (1). When this registration is filed, the Division will consider whether, as a result of the initial sale for intangibles, a finding is required that the securities now to be issued will be disposed of or purchased on grossly unfair terms or in a manner likely to deceive or defraud purchasers or sellers. If the Division finds that no such result would occur, it will allow the registra-

²³ "The sale of its securities by a corporation organized under the laws of this state when no part of the securities to be sold is issued directly or indirectly in payment or exchange for intangible property or for property not located in this state, and when the total commission, remuneration, expense or discount in connection with the sale of such securities does not exceed three per centum (3%) of the total sale price thereof."

²⁴ "'Intangible property' shall mean and include patents, copyrights, secret processes, formulae, services, good will, promotion and organization fees and expenses, trademarks, trade brands, trade names, licenses, franchises, and any other assets treated as intangible according to sound accounting practice."

tion by description under Section 8624-6 (1). If, however, such finding is made, the Division will suspend the registration by description or may try some other method to insure the safety of the potential investor.²⁵

If, for example, a corporation wishes to register by description under Section 8624-6 (1) and some of its securities are to be sold for items other than cash, the Division requires an appraisal of the value of such items. The Division may further consider, on the basis of such valuation, whether or not the issuance will be on grossly unfair terms or in such a manner as to deceive or defraud purchasers or sellers.²⁶

Section 8624-6 (2) provides:

"(2) The sale of its shares or subscriptions for its shares by any corporation organized under the laws of this state or by any foreign corporation qualified to do business in this state, when the total number of shareholders does not, and will not after such sale, exceed fifteen (15); provided that such securities are issued and disposed of for the sole account of the issuer, in good faith and not for the purpose of avoiding the provisions of this act."

This section is also very important for a small corporation that can satisfy its requirements. However, it must be remembered that the number of *record* stockholders does not necessarily determine whether there are fifteen or more stockholders. The number of record stockholders, taken in conjunction with the number of beneficial owners of the stock, must not exceed fifteen.²⁷ The question whether a corporation that wishes to pay some commission for the sale of its securities, but intends to issue securities to less than fifteen persons, may take advantage of this subdivision, was answered in the negative by the Division of Securities.²⁸ The Division took the position that the securities must be issued for the sole account of the issuer and that it was intended that the issuer should have the total gross proceeds of the sale.

Section 8624-6 (4) allows registration by description if the corporation makes the offering and sale exclusively to its own security holders, and if no remuneration is paid other than to a dealer who has agreed to purchase all such securities not taken

²⁵ Regulation E-1 of the Division of Securities.

²⁶ Regulation R-6A of Ohio Division of Securities.

²⁷ Regulation R-6-C of the Ohio Division of Securities.

²⁸ Administrative Ruling 10, Ohio Division of Securities.

by the security holders. Under this subdivision, the Division has held that in cases where a corporation proposed to offer certain of its treasury shares for sale to a limited group of officers, directors or employees, all of whom were shareholders of the corporation, the issuance could not be registered pursuant to Section 8624-6 (4). The Division took the position that such an offering is made to less than a class of security holders and that the section as drafted contemplates a general offering to all of a class of security holders.

Section 8624-5 is an additional method of registering securities by description. It encompasses securities transactions which probably would be unable to qualify under Section 8624-4 or Section 8624-6 and the securities themselves would not be exempt under Section 8624-3. Such securities are included in this section because their relative merit and other supervision is considered sufficient to protect investors. A corporation in business for at least three years with a good earning record should consider the availability of this section before the issuance of new securities.

Section 8624-8 is the section which specifically sets forth the information required to register securities by description.

Section 8624-7 provides that the securities transactions enumerated in Sections 5 and 6 may be registered by description upon compliance with Section 8624-8.

Registration by Qualification.

Section 8624-10 provides the method for registration by qualification. That is, securities which are not in and of themselves exempt under Section 8624-3, nor subject to a transaction exemption under Section 8624-4, nor able to be registered by description under Sections 8624-5 or -6, *must* register under Section 8624-10. This section sets forth the amount of detailed information required, which is closely akin to a registration statement under the Federal Act. Subdivision (k) of Section 8624-10 provides that in lieu of the information required under Section 8624-10 a copy of a registration statement filed pursuant to the Federal Securities Act of 1933 may be submitted. This section further provides that in addition to the detailed information required, the Division must find, before approval is given, (1) that the business of the issuer is not fraudulently conducted; (2) that the purpose of the offer or disposal of the securities is not

on grossly unfair terms; and (3) that the plan of issuance and sale of the securities would not defraud or deceive or tend to defraud and deceive purchasers.

What constitutes "unfair terms" is a matter of discretion which is vested in the Division of Securities. For example, consider the case of a corporation whose articles provide for an authorized issuance of 500 shares of no par common stock, and 1,000 shares of cumulative preferred stock with a par value of \$50. The preferred stock has no voting rights notwithstanding the extent of default in dividends; the preferred stock is to be sold to the public at \$50 per share and common stock is to be sold to members at \$1 per share. The Division has held that *prima facie* such an offer is grossly unfair, since the holders of the preferred stock who have contributed substantially all of the cash and bear the entire risk are given no capacity to protect their interest. The Division must be shown proof that the purchasers of the preferred stock will be fully informed persons competent to understand the limitations of their preferred stock.²⁹ There are other pointed illustrations.

Suppose a corporation proposed to issue preferred stock on which dividends will not be cumulative. The Division has held that the absence of cumulative dividends is *not* grossly unfair if the holders of preferred stock would be entitled to exercise a vote upon repeated failure to pay dividends.³⁰ Again, suppose a corporation attempts to qualify Class A and Class B common stock. Class A shares are to be non-voting; class B shares, with voting rights, are to be issued solely to management. Furthermore, the directors are given the power to allocate arbitrarily to each class of shares the proportion of earnings to be paid as dividends, even though such action would result in the total exclusion of dividends for the other class of shares. The Division has held that such an offering would be on grossly unfair terms, and would tend to deceive and defraud purchasers.³¹ Again, suppose a corporation proposes to sell shares to its promoters at a certain price. Shortly thereafter it intends to offer to the public shares of the same class at substantially higher prices. The Division has held this public offering to be on grossly unfair terms if there is

²⁹ Administrative Ruling 17, Ohio Division of Securities.

³⁰ Administrative Ruling 18, Ohio Division of Securities.

³¹ Administrative Ruling 19, Ohio Division of Securities.

no intervening improvement in the financial status of the corporation between the dates of the two offerings.³²

Section 8624-14 provides for provisional registration by qualification. Upon written consent, an issuer who is solvent and of good business repute may sell its securities before qualification is complete. Within thirty days thereafter, the application for qualification must be made.³³ Although the effective date of the federal registration may be advanced, the registration must be complete before any offering or sale is made.

Section 8624-16 gives broad powers to the Division to supervise and revoke registration by description and qualification and to prohibit buying, selling or dealing in particular securities, if the Division finds that (1) a violation of any of the provisions of the Act; (2) the issuer has fraudulently conducted its business; (3) the issuer has been or is about to engage in deceptive practices; (4) the issuer is disposing of or purchasing the security on such grossly unfair terms as to deceive or defraud; (5) the issuer has disregarded the rules and regulations applicable to the security or transaction; or (6) the issuer is selling securities under registration by description or qualification when the issuer is insolvent. This section also sets up machinery for hearings and authorizes actions against persons who knew false statements were contained in the registration statements or applications for qualification.

We have seen that the Division will refuse to qualify certain securities under Section 8624-10 if they are offered on terms which are considered grossly unfair or if they will deceive or defraud. Section 8624-16 expands this power of the Division to securities registered by description and to securities and transactions which are exempt. For example, schemes in which the promoters say that 75% of the investment will go into United States Government E Bonds and 25% into the venture itself, and which allows varying degrees of interest to the purchaser, have been barred in Ohio.³⁴

It would be advisable for a proposed corporation that wishes to authorize certain questionable classes of stock in its articles or charter, first to submit such a proposition to the Division of

³² Administrative Ruling 21, Ohio Division of Securities.

³³ There is no comparable provision in the Federal Securities Act of 1933.

³⁴ Release of Ohio Division of Securities January 21, 1948.

Securities. This step would permit necessary reformatations prior to, rather than after, the filing of the articles.

Section 8624-24 provides for appeals from the findings of the Division under Section 8624-16 and such appeals are governed by Sections 154-61 to 154-73 of the General Code of Ohio.³⁵

Section 8624-27 is the statute of limitations which sets up a maximum of three years for any prosecution or action based on this Act. Section 8624-28 gives the Division of Securities investigative powers, including powers of subpoena, and Section 8624-29 provides for contempt proceedings for failure to comply with orders of the Division. Section 8624-30 provides for injunction for failure to comply, and Section 8624-31 provides that the Division may obtain an injunction for any violation of the act.

FRAUD AND CIVIL LIABILITY UNDER FEDERAL LAW.

Of particular interest to all corporations, large and small, dealing in any manner with securities, is the fraud and civil liability sections of both the Securities Act of 1933 and of the Blue Sky Laws of the various states.

The fraud section of the Federal Act is found in Section 17.³⁶ This section itself provides that the exemptions of Section 3 which have been discussed earlier have no application to Section 17; that is, even where a legitimate exemption has been effectuated,

³⁵ Administrative Procedure Act.

³⁶ "Sec. 17. (a) It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

"(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of the untrue statement of a material fact or any omission to state 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

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

"(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

"(c) The exemptions provided in section 3 shall not apply to the provisions of this section."

if fraud, as defined in Section 17, has been practiced, the issuer or person committing the fraudulent act is liable under the provisions of this section. It is evident that the provisions of Section 17 (a) are more favorable to the buyer than is the common law rule of deceit. Specifically, Section 17 (a) seems to be aimed at the so-called half or partial truths which are so difficult to reach under the unyielding provisions of the common law. Generally speaking, the common law rule of deceit and fraud requires (1) that there be a misstatement of a material fact; (2) with knowledge that the fact stated is false; (3) that there be intent that the fraudulent statement be relied upon; (4) that such fraudulent statement is relied upon; (5) that damages are suffered as a consequence thereof.

While neither Section 17 (a) (1) nor Section 17 (a) (3) specifically requires that the misstatements be material, Section 17 as a whole has apparently dispensed with scienter, proof of reliance, proof of damages and the distinction between fact and opinion.

The federal statute covering civil liability is Section 12 of the Securities Act of 1933:

"SEC. 12. Any person who—

(1) sells a security in violation of section 5, or

(2) 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 communications, 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 the tender of such security, or for damages if he no longer owns the security."

This section also specifically includes the exempt securities found under Section 3 of the Federal Act.

Under Section 10 of the Securities and Exchange Act of 1934, the Securities and Exchange Commission has promulgated Rule X-10-B-5, which generally incorporates the language of Section 17 (a) of the Securities Act of 1933, but is broader, and gives the additional remedy of applying the right to relief to the *purchase* as well as to the *sale* of securities. This rule now affords the optimum civil remedy under the federal legislation.

FRAUD AND CIVIL LIABILITY UNDER THE BLUE SKY LAWS (OHIO).

Section 8624-25 of the General Code of Ohio is the section which sets forth the criminal liability for violation of the Ohio Act. It provides, among other things, for imprisonment not exceeding five years or a fine of \$5,000 or both. The section prohibits false statements concerning material or relevant facts made orally, in applications, or in a prospectus submitted for the purpose of complying with the provisions of the act pertaining to registration or qualification of securities. This section also provides for liability of an officer, director or trustee of an issuer, who, knowing that the issuer is insolvent, sells securities for said issuer without disclosing the fact of such insolvency. This section also provides penalties for anyone engaged in any practice declared illegal by the Ohio Act.

Section 8624-26 provides that anyone accused under this Act shall be deemed to have knowledge of the facts where the exercise of reasonable diligence would have revealed such facts to him.

Section 8624-35 provides the civil liability for fraud. This statute is much narrower than the comparable federal statute, and it provides that any person offering any securities for sale and who, in written or printed circular, advertisement or prospectus, had made false statements of material facts therein, would be liable to the purchaser, unless that person can establish that he had no knowledge of the publication of these facts or that he had reasonable grounds to believe that the statements were true. The section further provides that when a corporation is the issuer, each director shall be liable unless he can show that he had no knowledge of the publication or that he had just and reasonable grounds to believe that the statements were true. The statute provides further that the lack of reasonable diligence

to act shall constitute knowledge of the publication and of the falsity of the statement.

Section 8624-48 (a) deals with sales or contracts for sales of securities which are voidable at the election of the purchaser. The statute provides that the person making such sale or contract for sale and every person who aided the seller shall be jointly and severally liable to the purchaser. Upon the tender to the seller in person or in court of the securities sold or of the contract made, such sale shall be void unless the court shall determine that the violation of the seller did not materially affect the protection contemplated by the violated provision. It may be observed that this statute is most stringent, and throws upon the deceived person an almost unsurmountable burden of proof to make out his case. It can be seen that the statement must be "material" and that if, by the time the deceived purchaser learned of the falsity of the statements and had made demand upon the seller, he had sold the securities, his rights are lost.

Section 8624-32 is a most interesting section, and one which apparently would provide a most effective remedy. This section presumably allows an aggrieved individual, as well as the Division of Securities, to ask for the appointment of a receiver to take over the assets of an issuer if these assets were derived by means of any act or practice made illegal, prohibited or declared to be fraudulent by the Securities Act. If such assets are so commingled with others that they cannot be readily identified in kind, authority is given to take over all of the assets.

This summary type of relief, available to defrauded purchasers, seems to afford an excellent, although up to now infrequently used, remedy. For example, if a corporation issues a security and gives fraudulent information to induce the purchase, the purchaser, upon learning of this fraud, does not have to wait to file an action either in rescission or for damages, which action, even if successful, might find all corporate funds dissipated. Instead, having shown facts entitling him to relief, the purchaser may have a receiver appointed immediately and thereupon the court has jurisdiction over all questions arising in the proceedings and may make such orders and decrees as justice and equity shall require.

Section 8624-41 provides the method by which securities which have been issued without compliance with the act, may be registered. Such securities must be registered by qualifica-

tion, if at all. If it appears that no person will be injured by such registration by qualification and all facets of the qualification requirements are met, such securities may be qualified. This section, however, does not negate the responsibility either under the criminal or civil liabilities section of the Act. However, as a practical matter, if no fraud is present, the Division has authority to lessen these stringent requirements.

Section 8624-47 is an important section which the small corporation or any individual must consider carefully if such individual or corporation desires to sell or in any way deal with real estate not located in the State of Ohio. Section 8624-2 (2) includes in the definition of securities, "real estate not situated in the state and any interest in real estate not situated in the state."

Section 8624-47 further provides that no person other than an actual bona fide owner selling for his own account in a single transaction and not by way of repeated or successive transactions . . . may sell without complying with this section. Therefore, even a bona fide owner is apparently limited to a single transaction but thereafter must qualify under this section. This section requires extremely detailed information concerning the proposed transaction for the purpose of assuring that the property will not be sold, leased or dealt with on grossly unfair terms, or in a method or manner that may deceive or defraud purchasers in this state. The Division has the power to examine the premises at the expense of the applicant. This section does not apply however to real estate situated within 25 miles of the line between Ohio and another state.

CONCLUSION.

It appears that the small corporation will have little trouble if it is careful in its approach to its securities problems. Its most important problem is to be aware of the impact of the various laws upon its issuance of securities, and once so aware, it can avoid the pitfalls of non-compliance.