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Prereorganization Negotiations and Securities Act Section 5(c): A Proposed Solution to the Gunjumping Problem

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NOTES

Prereorganization Negotiations and Securities
Act Section 5(c): A Proposed Solution to the Gunjumping Problem

The author focuses on the apparent conflict between section 5(c) of the Securities Act of 1933, which prohibits any "offer to sell" a security before a registration statement is filed, and the need for prereorganization negotiations with shareholders of the corporation to be acquired. Reviewing the possible exemptions from registration which might apply to the reorganization transaction, he concludes that often no exemption will be available and some form of registration will be required. The author then evaluates the approach currently taken by the SEC to permit these prereorganization negotiations. After demonstrating the numerous difficulties caused by this approach, he proposes a new rule which would avoid the problem of prereorganization gunjumping and at the same time eliminate the unnecessary burdens on the acquired-corporation negotiators which the SEC's present position imposes.

I. INTRODUCTION

CORPORATE ACQUISITIONS and reorganizations have become a significant means of distributing securities to individual investors. Although the investor protection afforded by the Securities Act of 1933 (Securities Act) is just as critical whether the recipient of the security is a shareholder of an acquired corporation or a new investor purchasing for cash, some aspects of these reorganization transactions do not fit smoothly into the framework of an act principally structured to deal with conventional offerings. This Note will consider the problems encountered under the Securities Act in dealing with the negotiations leading up to a reorganization and will analyze the tensions created by the method by which the Securi-

1 In 1968 one authority concluded, "In terms of the number of transactions and the value of securities issued, acquisitions now rival, if they do not surpass, conventional offerings as a format for the issuance of stock." Schneider, Acquisitions Under the Federal Securities Acts — A Program for Reform, 116 U. PA. L. REV. 1323, 1340 (1968).


3 See notes 17-19 infra and accompanying text.

4 The reorganization transactions dealt with in this Note include (1) mergers and consolidations, (2) exchanges of securities for securities, and (3) exchanges of securities for assets. Following the scheme for classifying tax-free reorganizations contained in INT. REV. CODE OF 1954, §§ 368(a)(1)(A)-(C), these transactions will be termed A, B, and C reorganizations, respectively, though not all the reorganizations referred to herein would necessarily meet the specific requirements of the Code for nonrecognition treatment.

ties and Exchange Commission (SEC) currently attempts to resolve them.

Section 5(c) of the Securities Act\(^6\) prohibits offers to sell or to buy securities prior to the filing of a registration statement.\(^7\) When a prefiling offer to sell is made — a practice termed "jumping the gun" — the offeror is liable to those who purchase securities from him for rescission or, if the purchaser no longer owns the security, for damages.\(^8\) Because of the broad definition given "offer to sell" in section 2(3) of the Securities Act,\(^9\) the preliminary negotiations between potential parties to a reorganization may be held to violate section 5(c).

A good example of the opportunities for gunjumping in a reorganization transaction is provided by Chris-Craft Industries, Inc. v. Bangor Punta Corp.,\(^10\) which involved a battle between Chris-Craft and Bangor Punta for control of the Piper Aircraft Corporation. In January 1969, Chris-Craft began to acquire Piper stock, first on the open market and then through a series of tender offers. The Piper family,\(^11\) seeking to thwart a takeover by Chris-Craft, began negotiating with Bangor Punta. On May 8, 1969, these negotiations resulted in an agreement,\(^12\) and Bangor Punta issued a press release announcing its intention to make a tender offer for the remaining


It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .

\(^{7}\) The basic policy reason for preventing offers prior to filing is to prevent any possibility of psychological commitment on the part of offerees until there is structured information on file with the Securities and Exchange Commission. See SEC v. Continental Tobacco Co., 463 F.2d 137, 154-55 (5th Cir. 1972).

\(^{8}\) Securities Act § 12(1), 15 U.S.C. 77l(1) (1970). To recover under section 12(1) the offeree must ultimately purchase the security. However, the SEC has injunctive power that may be exercised even though there are no purchasers, Securities Act § 20(b), 15 U.S.C. § 77t(b) (1970), and there are criminal penalties for illegal offers without sales. Id. § 24, 15 U.S.C. § 77x (1970).

\(^{9}\) 15 U.S.C. § 77b(3) (1970). "Offer" includes "every attempt or offer to dispose" of a security. Id. This language has been interpreted broadly. 1 L. Loss, SECURITIES REGULATION 181, 512 n.163 (2d ed. 1961) [hereinafter cited as LOSS]. See generally SEC, DISCLOSURE TO INVESTORS — A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS — THE WHEAT REPORT 127-35 (1969) [hereinafter cited as WHEAT REPORT].

\(^{10}\) 426 F.2d 569 (2d Cir. 1970) (en banc).

\(^{11}\) The Piper family owned 31 percent of the outstanding Piper stock.

\(^{12}\) The Piper family agreed to exchange their Piper stock for specified Bangor Punta securities; Bangor Punta agreed to make a tender offer to Piper shareholders in an attempt to obtain more than 50 percent of the outstanding Piper stock. 426 F.2d at 571.
Piper shares. The Second Circuit determined that the press release constituted an offer to sell Bangor Punta shares and held that, since no registration statement had been filed by Bangor Punta, this offer violated section 5(c).\(^\text{13}\)

The facts involved in *Bangor Punta* suggest an earlier instance of gunjumping, not considered by the Second Circuit, but more relevant to the present discussion than the tender offer question. Since an offer must have been made by Bangor Punta to the Piper family members during the negotiations which led to the agreement, it is arguable that the gun was jumped prior to the issuance of the press release.\(^\text{14}\) All B reorganizations, like the transaction involved in *Bangor Punta*, have always contained the seeds of such gunjumping. And since the recent promulgation of SEC Rule 145,\(^\text{15}\)

\(^{13}\)Id. at 576. This part of the case revolved around whether the press release was exempted from the definition of "offer to sell" as a notice of a proposed offering under SEC Rule 135, 24 Fed. Reg. 5117 (1959), as amended, 17 C.F.R. § 230.135 (1973). The court held that the categories of information allowed under the rule are exclusive and that, because the press release assigned a value to the offered Bangor Punta securities, it did not fall within the rule.

The litigation between Chris-Craft and Bangor Punta has been both protracted and involved and may not yet be over. After the issuance of the May 8, 1969, press release, the SEC sought a permanent injunction against violation of section 5(c) by Bangor Punta and Piper, and with the parties' consent the injunction was granted. SEC v. Bangor Punta Corp., [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,428 (D.D.C. 1969). Chris-Craft then sued Bangor Punta and Piper, but the district court held there had been no violation of the securities laws and dismissed a motion for a preliminary injunction. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 303 F. Supp. 191 (S.D.N.Y. 1969). On appeal, the Second Circuit affirmed the denial of the preliminary injunction, but holding that section 5(c) had been violated by the issuance of the press release prior to registration, remanded the case. Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970). On remand, although the district court found violations by Bangor Punta and Piper of the securities laws, it denied all relief to Chris-Craft. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 337 F. Supp. 1128 (S.D.N.Y. 1971). The district court also dismissed a counterclaim brought by Bangor Punta. Bangor Punta Corp. v. Chris-Craft Indus., Inc., 337 F. Supp. 1147 (S.D.N.Y. 1971). Meanwhile, the SEC had sued Bangor Punta for a permanent injunction against further violations and an order requiring Bangor Punta to offer Piper shareholders who had tendered their stock the right to rescind. The district court granted the latter motion, but denied the former. SEC v. Bangor Punta Corp., 331 F. Supp. 1154 (S.D.N.Y. 1971). All three of these district court decisions were appealed. (By this time, Chris-Craft had dropped its claim that Bangor Punta had violated section 5(c) and was asserting violations of the antifraud provisions.) The Second Circuit upheld the district court's decisions in the *SEC* and *Bangor Punta* cases, but reversed the decision in *Chris-Craft*. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 94 S. Ct. 231, 232 (1973).

\(^{14}\)Indeed, since the Piper family contracted to exchange their Piper stock with Bangor Punta, see note 12 *supra* and accompanying text, a sale was consummated during the negotiations in contravention of Securities Act § 5(a)(1), 15 U.S.C. § 77e(a)(1) (1970).

which provides that in certain instances A and C reorganizations may involve “offers to sell,” the potential for gunjumping during negotiations now exists in A and C reorganizations as well.\textsuperscript{16}

Applying section 5 to reorganizations means that offers inherent in prereorganization negotiations must somehow be legitimized. As this Note will describe, the method currently used by the SEC to do so causes substantial problems. Nonetheless, valid reasons exist for subjecting reorganization transactions to the section 5 disclosure requirements. Although the exchange of securities in a reorganization differs in many ways from an initial distribution (the situation to which section 5 was primarily intended to apply),\textsuperscript{17} the need for the protection which structured disclosure affords the acquired corporation’s shareholders is much the same as the public’s need for such disclosure generally.\textsuperscript{18} Mere ownership of stock in a corporation about to be acquired, even if that ownership amounts to control, does not guarantee an ability to evaluate the stock of the acquiring corporation.\textsuperscript{19} Information is needed. And the fact that negotiations are underway does not necessarily ensure that the target corporation’s negotiators will have access to the needed information or the ability to extract it. It is important therefore that the acquiring corporation be required to disclose relevant information about itself both during the prereorganization negotiations and in the time between negotiations and the actual issuance of the securities.

At the same time, there are compelling reasons for deferring registration until the negotiation process has been completed. Clearly, the plan of reorganization ordinarily cannot be carried out until a final agreement on all the terms and conditions of the transaction has been reached.\textsuperscript{20} Also, most state corporation laws require that for some types of reorganizations the board of directors must ap-

\textsuperscript{16} Prior to January 1, 1973, under SEC Rule 133(a), 17 C.F.R. § 230.133(a) (1973), \textit{rescinded}, SEC Securities Act Release No. 5316, pt. I (Oct. 6, 1972), no “sale,” “offer,” “offer to sell,” or “offer for sale,” occurred for the purpose of section 5 in an A or C reorganization if all the conditions of the rule were satisfied. Since registration was not required in such reorganizations, the gun could not be jumped during prereorganization negotiations. For a discussion and criticism of rule 133, see I Loss 518-39 and \textit{Wheat Report}, \textit{supra} note 9, at 251-96.

\textsuperscript{17} I Loss 183.


\textsuperscript{19} See Schneider & Manko, \textit{supra} note 5, at 993.

\textsuperscript{20} While it is possible for an acquiring corporation to engineer a tender offer (B reorganization) without consulting with the acquired (target) corporation, the problems encountered by Chris-Craft Industries demonstrate the pitfalls of failing to get the target corporation’s prior approval of the transaction. See notes 10-13 \textit{supra} and accompanying text.
prove the transaction and then submit it for shareholder approval.\textsuperscript{21} The resolution submitted to the shareholders has to include the terms of the reorganization, which must be worked out in the prior negotiations.

Moreover, as a matter of fairness and practical necessity, the issuer (the acquiring corporation) should be permitted to complete negotiations and to achieve finality of agreement before being required to file a registration statement. First, the registration statement must contain information relative to the transaction, information which can be obtained only after negotiations have been concluded.\textsuperscript{22} Second, should the issuer want to circumvent the registration requirements entirely through the use of the section 3(a)(10) exemption for securities issued pursuant to an order of a court or governmental authority after a hearing on fairness,\textsuperscript{23} he must know the terms of the transaction before he applies for the order.\textsuperscript{24} Third, it may be necessary to establish the terms of the reorganization if the issuer plans to seek an exemption from state blue sky laws.\textsuperscript{25}

\textsuperscript{21} E.g., ALI-ABA MODEL BUS. CORP. ACT §§ 71-73, 79 (1969 version) [hereinafter cited as MBCA]. Under MBCA § 73 the board of directors of each constituent corporation in an A reorganization must approve the transaction, then submit a resolution for shareholder approval. No such requirement exists for a B reorganization, although sometimes the board of the acquired corporation will voluntarily pose the question before the shareholders. For a C reorganization MBCA § 79 requires approval by the shareholders of the acquired corporation only.

\textsuperscript{22} See Securities Act schedule A, 15 U.S.C. § 77aa (1970). The information available only after finalization of the agreement includes that required by item (13) (use of proceeds from securities), item (16) (offering price of securities), item (21) (information concerning property to be acquired with proceeds from securities), and item (27) (profit and loss statements for acquired business). Nonetheless, prospective acquiring corporations may periodically register securities "for the shelf," so that registered securities are available when they find an attractive target corporation. See Schneider, supra note 1, at 1338 n.50. Shelf registration is one obvious method of avoiding the problem of negotiation gunjumping, but the last sentence of Securities Act § 6(a), 15 U.S.C. § 77f(a) (1970), which states, "A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered,\" has been interpreted by the SEC as prohibiting shelf registration. See 1 Loss 296-98. But the portion of section 2(3) dealing with warrants and rights implies that shelf registration was contemplated by the Act. See id. at 299-300.

\textsuperscript{23} See notes 47-48 infra and accompanying text.

\textsuperscript{24} In states that have adopted provisions similar to UNIFORM SECURITIES ACT § 401(j)(6)(C), which incorporates the rule 133 "no sale" theory, see note 16 supra, into the definition of "sale" and "offer," A and C reorganizations are all exempt. In states that have no such exemption, or where a B reorganization is involved, the need for blue sky registration may be eliminated by state provisions similar to Securities Act § 3(a)(10). See, e.g., OHIO REV. CODE ANN. § 1707.04 (Page 1964), discussed at note 44 infra. But see text accompanying note 24 supra. In states that have neither of these exemptions, the issuer may have available an exemption for securities that are listed or approved for listing upon notice of their issuance on enumerated
Finally, in most cases the acquiring corporation will want some assurance of the viability of the proposed reorganization before undertaking the large expense of registration.  

II. REORGANIZATIONS AND THE REGISTRATION REQUIREMENT

In view of the extremely broad definition given “offer to sell” by section 2(3), there is little chance that an acquiring corporation can successfully conduct prereorganization negotiations with the target corporation’s managing shareholders without making a statutory offer. If no exemption from registration applies to this transaction, the negotiations will constitute gunjumping unless a registration statement is filed before the negotiations begin. This section will discuss the circumstances under which reorganizations require registration and consider some of the exemptions that might be available.

A. Treatment of Reorganizations Under the Securities Act

1. B Reorganizations

In a B reorganization the acquiring corporation offers to exchange its securities for target corporation securities. Regardless of whether the acquiring corporation negotiates with target company management, it ultimately makes the offers to buy and to sell directly to the stock exchanges. See, e.g., UNIFORM SECURITIES ACT § 402(a)(8); OHIO REV. CODE ANN. § 1707.02(E)(1) (Page 1964). For the securities to qualify for exchange listing, however, the terms of the transaction must be known. See, e.g., NEW YORK STOCK EXCHANGE, INC., COMPANY MANUAL at B-37 (1959).

26 But see note 21 supra.

27 See note 9 supra and accompanying text.

28 It can perhaps be argued, however, that if the acquiring corporation plans to issue new securities to carry out the exchange, that is, if the acquiring corporation does not have sufficient authorized but unissued securities already on hand, it is not in a position to offer and therefore cannot make an offer to sell these securities. Such an argument would most likely fail, though, since the issuance of the new securities is within the control of the acquiring corporation and will have been planned for when the negotiations begin.

29 If no registration statement has been filed, the acquiring corporation’s offer to sell will violate section 5(c). See note 6 supra. In addition, if any of the acquired corporation’s management shareholders accept the offer, section 5(a)(1), which prohibits the sale of securities before the registration statement becomes effective, will be violated as well. See note 14 supra. Even if a binding contract is not formalized, if acquired-corporation management control sufficient stock to satisfy shareholder approval requirements, see note 21 supra, their approval of the reorganization at the board level may violate section 5(a)(1).

target-company shareholders. As a result, there is a classic section 2(3) "offer," and the acquiring corporation must register its securities.

2. A and C Reorganizations: Rule 145

Historically, A and C reorganizations were treated differently from B reorganizations as a result of SEC Rule 133, which said that no sale occurred in A and C reorganizations.\(^{31}\) Since the promulgation of rule 145,\(^{32}\) which reverses the rule 133 "no sale" approach, this dichotomy of treatment has ended. Basically, rule 145 provides that an "offer, offer to sell, offer for sale, or sale" shall be deemed to be involved, within the meaning of Section 2(3) of the Act" in the case of any reclassifications, mergers or consolidations, and transfers of assets where "pursuant to statutory provisions . . . or pursuant to provisions contained in its certificate of incorporation or similar controlling instruments, or otherwise" such transactions are "submitted for the vote or consent of . . . security holders."\(^{33}\) If a prospective reorganization is covered by rule 145, some form of registration will be required.\(^{34}\)

While means of avoiding the application of rule 145 exist, the rule is sufficiently all inclusive to make any escape from the registration requirement for securities issued or exchanged in A or C reorganizations difficult. Rule 145 does not apply where shareholder approval of the transaction is not provided, whether by way of general corporate law, a charter provision or a gratuitous grant by the directors. But shareholder approval is usually a mandatory step in any A or C reorganization.\(^{35}\) The only express exception to the applica-

\(^{31}\) See note 16 supra.


\(^{34}\) Registration of a rule 145 transaction may be on SEC Form S-14, which permits the prospectus to be a proxy or information statement. Form S-14 may also be used by rule 145(c) underwriters, see notes 149-56 infra and accompanying text, when they resell their securities. SEC Securities Act Release No. 5316, pt. V.A, (Oct. 6, 1972).

\(^{35}\) Most state corporation statutes will require shareholder votes in A and C reorganizations. See, e.g., MBCA §§ 73, 79. Similarly, corporate charters may contain such a requirement. As originally proposed, rule 145(a) would have applied only in these two situations. SEC Securities Act Release No. 5246 (May 2, 1972). As finally adopted, however, rule 145(a) added after the provisions for shareholder approval by statute or charter the phrase "or otherwise," an addition which commentators have argued should be interpreted broadly. Schneider & Manko, supra note 32, at 812 & n.12. Also, while the rule originally referred to shareholder "vote," the words "or consent" were added to expand the shareholder approval condition. SEC Securities Act Release No. 5316, pt. II. B (Oct. 6, 1972).
tion of rule 145 to mergers and consolidations — where the sole purpose of the reorganization is to change the issuer’s domicile — is inapplicable to a reorganization involving two or more going concerns. And attempts to avoid the application of rule 145 to a sale of assets by not distributing the acquiring corporation’s securities to the acquired corporation’s shareholders within one year following shareholder approval of the transaction will most likely be futile. Finally, even if rule 145 is avoided, there may still be a section 2(3) offer to sell and, therefore, a required registration.

B. Exemptions from Registration

The preliminary note to rule 145 suggests one method of avoiding the negotiation gunjumping problem: "Transactions for which statutory exemptions under the Act, including those contained in Sections

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37 Rule 145 will apply to the distribution of the acquiring corporation’s securities, no matter how long the intervening time period, if it can be shown that the earlier transfer of assets by the acquired corporation was “part of a preexisting plan for distribution of such securities.” Rule 145(a)(3)(iv).

The theory underlying rule 145 is that in all forms of reorganizations, A and C as well as B, the acquiring corporation is in essence making an offer to sell to the individual shareholders of the acquired corporation. See SEC Securities Act Release No. 5316, pr. I (Oct. 6, 1972). Applying this characterization to a C reorganization presents a problem, however. While in a B reorganization the offer and exchange of securities is made directly to the acquired corporation’s shareholders, in both A and C reorganizations there are really two steps. In an A reorganization the acquiring corporation makes the offer, then, by operation of law, shares held in the acquired corporation are exchanged for shares in the acquiring corporation at the same time as the assets and liabilities of the acquired corporation are merged into the acquiring corporation. In a C reorganization the first step is the exchange of acquiring-corporation securities for acquired-corporation assets; the second step is the distribution of the acquiring-corporation securities by the acquired corporation to its shareholders, usually during the dissolution of the acquired corporation. Here, the offer from the acquiring corporation to the acquired-corporation shareholders takes place at the second step, when the offered securities reach the acquired-corporation shareholders. It is the nexus between these two steps that determines whether the transaction is within rule 145. Subparagraphs (i) and (ii) of rule 145(a)(3) apply the rule whenever the plan or agreement approved by the shareholders, see note 35 supra, provides for either the dissolution of the acquired corporation or the distribution of the acquiring corporation’s securities. Subparagraph (iii) causes the rule to apply when the board of directors, within one year after the shareholder approval, adopts a resolution requiring such dissolution or distribution. By adopting such a resolution more than one year later, the board may be able to avoid rule 145. The "preexisting plan for distribution" test of subparagraph (iv), a catchall provision which operates "notwithstanding (i), (ii), or (iii), above," would then become the determinative test of whether rule 145 applied.

38 See Schneider & Manko, supra note 32, at 814. The SEC noted in the release accompanying rule 145, for example, that although short-form mergers are not within the scope of the rule, such transactions are subject to the registration requirements of section 5, since there is a section 2(3) offer and sale. SEC Securities Act Release No. 5316, pt. II.B.2 (Oct. 6, 1972).
3(a) (9), 3(a) (10), 3(a) (11), and 4(2), are otherwise available are not affected by Rule 145." If one of these exemptions from registration is available for the reorganization, the negotiations can be freely carried on.

1. Section 3(a)(10): Securities Issued in Reorganizations Approved by a Court or Governmental Authority

Where the proposed reorganization is supervised by a court or governmental authority, the issuance of securities in the reorganization is exempt under Securities Act section 3(a)(10). The legislative history indicates that the basis for the exemption was the belief that continuing judicial or administrative supervision would fulfill the need for the protection afforded by registration. In practice, however, this ongoing supervision has not been achieved. One-shot initial approval of the transaction, obtained through a hearing on its fairness, is apparently all that is necessary to secure the exemption.

The design of section 3(a)(10) makes it possible for the acquiring corporation to obtain a simultaneous exemption at the federal and state levels by seeking a fairness order from the state blue sky administrator. For the order to effect an exemption under section 3(a)(10), several requirements must be met. First, "some adequate form of notice" of the fairness hearing must be given to

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40 15 U.S.C. § 77c(a)(10) exempts:
Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

41 See H.R. REP. No. 85, 73d Cong., 1st Sess. 16 (1933).
43 Exemption from state blue sky laws is discussed at note 25 supra.
44 Given the probable increase in demand for state fairness orders as a result of the SEC's adoption of rule 145, blue sky administrators may become less willing to sanction this means of escaping federal registration. For example, the Ohio Division of Securities has recently reevaluated its policy on granting fairness hearings under OHIO REV. CODE ANN. § 1707.04 (Page 1964), and enumerated several situations in which no hearing will be granted. Among its reasons for doing so were "the principles underlying Section 3(a)(10)" and "the widespread existence of [gunjumping] in connection with reorganization transactions." OHIO SECURITIES BULL., June 1973, at 4-5. The proposed Ohio Securities Act does not contain an equivalent to section 1707.04. S.B. 358, 110th Ohio Gen. Assembly, Reg. Sess. (1973).
all persons to whom securities will be issued. Second, the state agency must have express legal authorization to approve the fairness of the terms and conditions of the issuance and exchange of the securities. Third, and most important, the hearing procedure must be completed and final approval obtained before any offers may be made.

This necessity of securing final blue sky approval before the exemption may be had does not completely preclude the acquiring corporation from conducting preliminary negotiations with its target before it initiates the fairness hearing. First, it may always deal with nonshareholder management. Second, some leeway to establish at least the outlines of a reorganization plan is implicit in the “notice” required by the SEC as a condition for the exemption. Finally, Professor Loss has suggested that the acquiring corporation may be able to negotiate directly with shareholders in the target corporation, even to the point of obtaining tentative commitments, if state law so requires as a prerequisite for commencing the fairness hearing. But even if the Commission were willing to accept this suggestion, it is of little use in the numerous states which grant a fairness hearing irrespective of preliminary shareholder approval. Other than these exempted communications, section 5(c) will

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45 SEC Securities Act Release No. 312, § 1 (Mar. 15, 1935). Apparently the SEC, as a practical matter, does not view this notice as constituting an “offer to sell,” although such a communication to shareholders seems to meet the attempt-to-dispose test of section 2(3).


471 Loss 587-88; see SEC Securities Act Release No. 3000 (June 7, 1944). The section 3(a)(10) exemption will not operate retroactively to shield offers made before the fairness order is issued from the prohibitions of section 5(c). See generally 1 Loss 587-91.

48 See note 45 supra. Left open by the Commission is the question of the precise boundaries on this opportunity for the issuer to make these preexemption communications to offeree shareholders.

49 1 Loss 588. Professor Loss reasons that unless the communications necessary to secure these state-required indications of approval from offeree shareholders were exempted, “the operation of §3(a)(10) would be stymied.” Id.

50 The SEC has demonstrated a willingness to temper its rules to accommodate state law. See, e.g., SEC Rule 135(a)(6), 17 C.F.R. § 230.135(a)(6) (1973) (permitting notices of proposed offerings to include any statement required by state law). It is questionable, though, whether the Commission would accept something so at odds with its overall regulatory policies as an agreement for the sale of securities before a registration statement has been filed or an exemption sought. It has recently stated that if a final agreement is reached before the blue sky administrator passes on the issue, the section 3(a)(10) exemption is rendered unavailable. Fidelity Financial Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. § 78,840 (SEC 1972).

prohibit any attempt to work out the terms of a preliminary reorganization plan before obtaining the fairness order. And without some solid framework outlining the proposed transaction, the state fairness hearing is unlikely to be available, since there are no real terms for the blue sky administrator to approve the fairness of. As a result, the conditions for obtaining the section 3(a)(10) exemption place the issuer in much the same gunjumping predicament as the registration requirement does. Furthermore, there is another aspect of the section 3(a)(10) exemption that undercuts its usefulness in avoiding gunjumping. Although section 3 of the Securities Act expressly exempts securities, some of its subsections, including subsection (a)(10), are transaction exemptions. Therefore, absent later registration or an applicable exemption, securities issued in a section 3(a)(10) exempt reorganization cannot be resold by their recipients.

2. Section 4(2): Non-Public Offerings

Section 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering." Professor Loss has noted that "[t]hese few words support a substantial gloss." In SEC v. Ralston Purina Co., the principal decision on section 4(2), the Supreme Court stated that the private offering exemption should be interpreted in light of the statutory purpose. Since exempt transactions are those as to which "there is no practical need for [the bill's] application," the applicability of [section 4(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."
In other words, an offering is private if the offerees have possession of or access to information regarding the issuer which would otherwise be made available through registration. The number of offerees is an important factor in determining whether the offering is public or private. But relevant as well are the number of units offered and the manner of the offering. Also, the exemption has been interpreted to require that the offerees take the offered securities for investment and not for resale.

In an attempt to clear up the confusion surrounding the applicability of the section 4(2) exemption, the SEC has proposed rule 146, which will provide a nonexclusive "safe harbor" under section 4(2) for offerings that satisfy all of its five conditions. First, offers may be made only to those who the issuer, prior to making


The SEC has warned that "[t]he exemption does not become available simply because offerees are voluntarily furnished information about the issuer. Such a construction would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards and sanctions of the Act." SEC Securities Act Release No. 4552 (Nov. 6, 1962). Accord, 4 Loss 2632 (Supp. 1969). See Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971). But see Schneider, supra note 1, at 1335 n.42. But where securities are offered and sold to a few sophisticated and experienced institutional investors, the section 4(2) exemption can be satisfied by supplying the investors with information. In such cases, the institutional investors are deemed to have both access to the information, by virtue of their bargaining position, and the ability to extract, analyze, and use it. See Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. § 91,523, at 94,970 (S.D.N.Y. 1965).


There is no minimum number of offerees below which the exemption presumptively applies. Id.; see Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971); SEC Securities Act Release No. 285 (Jan. 24, 1935); 1 Loss 660-64; 4 id. at 2644-46 (Supp. 1969). But see Schneider, supra note 1, at 1335 n.42. Furthermore, the SEC and the courts have gone beyond the mere number of offerees, and in a sense have combined the number and offeree knowledge factors by considering the relationship of the offerees to one another and to the issuer. E.g., SEC v. Continental Tobacco Co., 463 F.2d 137, 158 (5th Cir. 1972); SEC Securities Act Release No. 285, § 1 (Jan. 24, 1935).


62 SEC v. Continental Tobacco Co., 463 F.2d 137, 159 (5th Cir. 1972). See generally 1 Loss 665-87. SEC Securities Act Release No. 4552 (Nov. 6, 1962) summarizes this requirement: "An important factor to be considered is whether the securities offered have come to rest in the hands of the initial informed group or whether the purchasers are merely conduits for a wider distribution."


64 "Transactions by an issuer which do not satisfy all of the conditions of this rule shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available for such transactions." Preliminary Note to Proposed SEC Rule 146, 38 Fed. Reg. 28956 (1973).
any offer, has reasonable grounds to believe are persons who possess "such knowledge and experience in financial and business matters that they are capable of evaluating the risks of the prospective investment . . . "65 If the issuer does not have reasonable grounds to believe the offeree possesses these qualifications, then (1) the offeree must utilize the services of an "offeree representative,"66 and (2) the issuer must have reasonable grounds to believe — once again, before any offer is made — that (a) the offeree representative has the capacity to evaluate the investment,67 and (b) the offeree is "able to bear the economic risk of the investment."68 Second, offers may not be made by any form of general advertising,69 and, at some time prior to the sale, there must be "direct communication" with each offeree or his representative.70 Third, the issuer must make available to the offeree or his representative prior to the sale (1) the same kind of information that is required by Securities Act


66 The requirements for qualifying as an "offeree representative" are specified in subparagraph (a)(1) of the proposed rule.


68 Proposed SEC Rule 146(d)(2), 38 Fed. Reg. 28957 (1973). The present version of subparagraph (d)(2) contains two changes from the original version. As originally proposed, the rule required that the offeree be able to bear the economic risks in all cases. Proposed SEC Rule 146(d)(2), 37 Fed. Reg. 26140 (1972). By limiting this requirement in the revised version, the Commission has apparently decided that in the instances where an offeree representative is not required, and the offeree therefore possesses the requisite financial expertise on his own, it will not second-guess his appraisal of his capacity to bear the risk. Second, the revised proposals do not apply the requirement to offerees in business combinations.

The proposed rule sets forth no standards for gauging when the offeree is "able to bear the economic risk." Commentators had suggested that the phrase might require that the security be suitable for the particular investor and his investment objectives. Schneider & Manko, supra note 1, at 992. But it now appears that the Commission intends a test less stringent than total "suitability." It has implied that the requirement will be satisfied if the investor has sufficient liquid assets that he can afford to hold unregistered securities for an indefinite time and sufficient overall resources that he can absorb a complete loss. SEC Securities Act Release No. 5430 (Oct. 10, 1973).

69 Proposed SEC Rule 146(c)(1), 38 Fed. Reg. 28957 (1973). The proposed rule prohibits any form of broadcast or newspaper advertising. It permits advertising by other written communication or by promotional meeting only if all of the recipients or persons who attend meet the requirements of paragraph (d), discussed at notes 65-68 supra and accompanying text.

70 Proposed SEC Rule 146(c)(2), 38 Fed. Reg. 28957 (1973). Subparagraph (a)(2) of the proposed rule defines "direct communication" to mean an opportunity for the offeree or his representative to ask questions and receive answers concerning the transaction from the issuer. This provision is substituted for the requirement in the earlier rule that the securities could be offered and sold only in a "negotiated transaction" between each purchaser and the issuer. Proposed SEC Rule 146(a)(3), (c)(1), 37 Fed. Reg. 26140 (1972).
schedule A and (2) the opportunity to obtain any additional information necessary to verify the accuracy of the required information, to the extent such information is possessed by the issuer or reasonably obtainable.\textsuperscript{71} Fourth, during any consecutive 12-month period, there must not be more than 35 persons who purchase from the issuer securities exempted from registration by section 4(2) or rule 146.\textsuperscript{72} Finally, the issuer must take steps to ensure that the securities issued in the transaction will not later be distributed to the public.\textsuperscript{73}

\textsuperscript{71} Proposed SEC Rules 146(e)(1)-(2), 38 Fed. Reg. 28957 (1973). Subparagraphs (e)(1)(i) and (e)(1)(ii) and the accompanying note provide that, if the offeree enjoys an employee relationship or economic bargaining power with respect to the issuer that enables him to obtain the information, providing access to the information is sufficient; otherwise, the offeree must be furnished the information.

The requirements contained in paragraph (e), along with those contained in paragraph (d), see notes 65-68 supra and accompanying text, appear to be an extension of the "access plus ability to utilize" standard, discussed at note 59 supra, which was previously available primarily in offerings to institutional investors. Rule 146 does not expressly provide an exemption for offerings where the offerees have specific naturally acquired knowledge of the issuer, but such an opportunity for exemption survives by virtue of the prerule precedents under section 4(2) which the rule preserves. See note 64 supra.

Proposed rule 146 also requires that the issuer inform each purchaser in writing prior to a sale that:

\begin{itemize}
  \item A purchaser of the securities must continue to bear the economic risk of the investment for an indefinite period because the securities have not been registered under the Act and therefore are subject to the restrictions set forth in paragraph (h) hereof [discussed in note 73 infra] and cannot be sold unless they are subsequently registered under the Act or an exemption from such registration is available.
\end{itemize}


\textsuperscript{72} Proposed SEC Rule 146(g)(2), 38 Fed. Reg. 28958 (1973). Purchasers of not less than $150,000 of securities for cash are excluded from the count, but not from the requirements of the rule. Proposed SEC Rule 146(g) (3) (ii) (a), 38 Fed. Reg. 28959 (1973). While rule 146 places limits on the number of purchasers, under section 4(2) precedent the number of offerees had been the principal concern. 1 Loss 655.

Proposed SEC Rule 146(h), 38 Fed. Reg. 28959 (1973). These steps include (1) a reasonable inquiry to determine whether the purchaser is an "underwriter," (2) use of restrictive legends on the certificates, (3) issuing stop-transfer instructions, and (4) obtaining "investment letters" from the purchasers.

The "reasonable inquiry" standard provides needed protection for the issuer in a private offering. Under existing law, no matter how cautious the issuer is in securing assurances that the purchasers are acquiring the securities with the intent to hold for investment purposes required under section 4(2), see note 62 supra, it is always possible that the exemption may subsequently be lost. One purchaser could decide to resell his securities shortly after issuance and consequently create a strong inference that the investment intent required of him was lacking at the time of purchase. See Securities Act Release No. 4552 (Nov. 6, 1962). By conditioning the exemption on a reasonable inquiry, rule 146 seems to permit the issuer to unlink the certainty of the exemption from the subsequent conduct of the purchaser, though such a result is at odds with the Commission's longstanding position that the issuer is at its peril to police the activities of private purchasers.
The problems encountered in applying section 4(2) and rule 146 to reorganizations can be illustrated by the following hypothetical situation, which will be used throughout the subsequent analysis. Assume that Y Corporation is interested in acquiring X Corporation. Y is a large publicly held corporation with securities registered under section 12 of the Securities Exchange Act of 1934 (Exchange Act). X has one class of voting stock, 60 percent of which is owned by the members of one family, as follows:

<table>
<thead>
<tr>
<th>SHAREHOLDER</th>
<th>PERCENT OWNED</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>26</td>
</tr>
<tr>
<td>B (A's father)</td>
<td>15</td>
</tr>
<tr>
<td>C</td>
<td>11</td>
</tr>
<tr>
<td>D</td>
<td>5</td>
</tr>
<tr>
<td>E</td>
<td>3</td>
</tr>
</tbody>
</table>

The remaining X stock is owned by 100 unrelated shareholders. X management consists of:

<table>
<thead>
<tr>
<th>NAME</th>
<th>POSITION</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>President, Chairman of the Board</td>
</tr>
<tr>
<td>C</td>
<td>Vice President, Director</td>
</tr>
<tr>
<td>D</td>
<td>Director</td>
</tr>
<tr>
<td>F</td>
<td>Secretary-Treasurer (owns 1% of the voting stock of X)</td>
</tr>
</tbody>
</table>

Y has approached X management concerning its interest in the acquisition. C has expressed some doubts about the family giving up control of X. E also has some doubts and as a result desires to be present during further discussions between the corporations. B has no interest in the conduct of the business and will not participate in the negotiations. He will go along with whatever his son, A, decides.

Without the benefit of proposed rule 146, it is doubtful that the issuer, Y, can obtain a private-offering exemption. Under prerule section 4(2) analysis, while the number of offerees was not conclusive, it was highly significant. That X corporation has 105 shareholder-offerees might alone be sufficient to prevent the exemption. The additional factor that not all of these shareholders stand in a position with respect to the issuer that will guarantee their access to relevant financial information places the exemption beyond

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75 See note 60 supra and accompanying text.
76 See note 59 supra and accompanying text.
reach. Unlike the issuer in a private offering for cash, Y Corporation cannot select and restrict membership in the offeree class. It is bound by the characteristics of X's shareholders at the time of the offer.\textsuperscript{77}

Y Corporation cannot seek to secure an exemption by confining its negotiations to the few dominant X shareholders who might qualify as permissible offerees for the private-offering exemption. The SEC has stated: "[Section 4(2)] does not exempt every transaction which is not itself a public offering, but only transactions 'not involving any public offering.' Accordingly, . . . the exemption is not available to securities privately offered if any other securities comprised within the same issue are made the subject of a public offering."\textsuperscript{78} The Y securities offered and sold to X Corporation's principal shareholders, who will participate in the negotiations, and those later offered and sold to all other X Corporation shareholders constitute a single issue,\textsuperscript{79} and together preclude the possibility of a section 4(2) exemption.\textsuperscript{80}

Under the present law, it appears that the private offering exemption will rarely be available in a reorganization transaction, except, perhaps where the acquired corporation is closely held.\textsuperscript{81} If,

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\textsuperscript{77} Schneider & Manko, supra note 5, at 991. The fact that reorganizations pose special problems for issuers in the application of section 4(2) was recognized by the \textit{Wheat Report}, supra note 9, at 293-94. It recommended the adoption of rule 181, which would have provided that offers and sales of securities "made solely in connection with the acquisition by the issuer of a bona fide going business to not more than 25 offerees" would be deemed to be transactions "not involving any public offering." \textit{Id.} app. VI-1, at 27. The SEC proposed the rule for adoption, Proposed SEC Rule 181, 34 Fed. Reg. 17181 (1969), but it was never adopted.


\textsuperscript{80} SEC Rule 152, 17 C.F.R. \textsection{} 230.152 (1973), provides that section 4(2) shall apply "to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering. . . ." (Emphasis added). The emphasized phrase makes the rule inapplicable to the hypothetical, where the offering to X shareholders was contemplated from the beginning.

\textsuperscript{81} One commentator states that experienced practitioners consider the exemption applicable in reorganizations where the acquired corporation has about 25 or fewer shareholders. Schneider, supra note 1, at 1335 n.42; cf. Schneider & Manko, supra note 5, at 994. But even in these close corporations, there is no assurance that every shareholder will possess the naturally acquired information or the capacity to extract and evaluate the information as required by the exemption. In a recent no-action letter, General Alloys Co., [1970-1971 Transfer Binder] CCH Fed. Sec. L. REP. \textsection{} 78,134 (SEC 1971), the SEC allowed nonregistered securities to be issued under a section 4(2) exemption in a B reorganization where the acquired corporation had 35 shareholders, consisting of four substantial shareholder-directors who negotiated the transaction for the acquired corporation, one additional principal shareholder, 21
however, the SEC adopts proposed rule 146, the exemption will become available in numerous reorganizations where publicly held corporations are being acquired. In the hypothetical situation, because the rule permits the use of an offeree representative, it is no longer necessary that each and every X shareholder qualify as a proper offeree. To facilitate representation of offerees in "business combinations," the rule takes a rather bold step and excepts from the definition of "offer" communications sent to shareholders by an executive officer, director, or affiliate of an acquired corporation for the purpose of soliciting their consent to his acting as their representative. By employing this procedure in the hypothetical, A could

partners or retired partners in a major accounting firm or close members of their families or trusts established by them, three personal acquaintances of those partners, a vice president of the acquired corporation, and five former employees of the acquired corporation or their transferees. The no-action letter does not explain the rationale behind the SEC position. But in light of the wide diversity of acquired-corporation shareholders, it is questionable whether they all had the requisite relationship with their own corporation, let alone with the issuer. Perhaps, in view of the representation of the offerees by the negotiating shareholders, cf. Proposed SEC Rule 146(a)(1), 38 Fed. Reg. 28957 (1973), discussed in note 66 supra, and the fact that after the transaction the acquired corporation's shareholders would own almost two-thirds of the acquiring corporation, the SEC believed that the need for Securities Act protection was minimal.

82 Business combination is defined to include "a reclassification, merger, consolidation, transfer of assets, exchange of securities or other similar business reorganization." Proposed SEC Rule 146(f)(1), 38 Fed. Reg. 28958 (1973).

83 Proposed SEC Rule 146(f)(3), 38 Fed. Reg. 28958 (1973). Given the strong policy reasons for extending the structured disclosure requirements to reorganizations, see notes 17-19 supra and accompanying text, rule 146 might go too far in its attempt to raze some of the special hurdles faced by acquiring corporations seeking to obtain private-offering exemptions. The only information that must be supplied in the solicitation are summary items such as:

(a) the name of the issuer of the securities to be offered and the names of other parties to the transaction;
(b) a brief description of the business of the parties to such transaction, and the anticipated time of the offering;
(c) a brief description of the transaction to be acted upon and the basis upon which such transaction will be made.

Proposed SEC Rule 146 (f)(3)(ii), 38 Fed. Reg. 28958 (1973). The officer, director, or affiliate who undertakes to act for target corporation shareholders needs to possess only the general qualifications required of all offeree representatives and must disclose to the offerees any existing or contemplated relationship between himself and the issuer, any compensation he is to receive from the issuer, and the terms of his transaction with the issuer if they are not identical to those available to shareholders generally. Proposed SEC Rules 146(a)(1), (f)(2), 38 Fed. Reg. 28957 (1973). Since, under subparagraph (e)(1) of the rule, the structured selling information can be made available to the offeree or his representative, there is no guarantee that the information which would have been required by registration will ever filter down to the individual shareholder. To the extent that the rationale for the section 4(2) exemption is that the offerees already possess (or possess the means to possess) all the information that would be disclosed by the registration process, see SEC v. Ralston Purina Co., 346 U.S. 119, 125-27 (1953), proposed rule 146 falls short of its proper mark. On the other hand, the proposed rule may signal an admission by the SEC that information
obtain authorizations to serve as offeree representative for each of the 100 unrelated X shareholders. If any of the X shareholders whom A solicits decides that they would prefer someone other than A to represent them, the rule provides that each shareholder may select his own offeree representative and may receive from the acquiring or acquired corporation the reasonable expenses of hiring him. As long as Y Corporation has reasonable grounds to believe, prior to making any overtures, that A, or any other offeree representatives selected in his stead, and the X shareholders like E, who choose to represent themselves, all possess the necessary business expertise, and Y makes available to them the information required by paragraph (e), the transaction may be eligible for section 4(2) treatment. The only obstacle is the number of X shareholders who will ultimately receive Y stock. An issuer who engages in no other section 4(2) transactions in a given year can make a reorganization offering to at least 70 unrelated persons. Unless exclusions can be found for the additional 35 X shareholders, the reorganization in the hypothetical will be deemed a public offering.

Notwithstanding the results for Y Corporation, proposed rule

in the hands of qualified surrogates, whether pursuant to section 4(2) or in a fully registered offering, is enough to satisfy the Securities Act's disclosure-to-investors requirements.

85 But see notes 92-93 infra and accompanying text. The "private" nature of the offering will be destroyed, though, if one or more X shareholders refuse to accept offeree representation, and Y has no reasonable grounds to believe they can qualify on their own. But given the provisions for reimbursing the expenses of obtaining independent representation, see text accompanying note 84 supra, the probability of these maverick shareholders ultimately deciding to go it alone seems slight. Nonetheless this prospect illustrates the rather curious operation of proposed rule 146. The acquired-corporation shareholder with some business sophistication is helpless, he cannot demand registration and must be content to receive information about the issuer which may be substantially inferior to that which registration would disclose. (For example, some issuers are permitted to use unaudited financial statements in discharging the information requirements if no audited statements are available. Proposed SEC Rule 146(e) (1) (ii) (b), 38 Fed. Reg. 28958 (1973).) The unsophisticated shareholder, on the other hand, is in effect given a blackball over the exemption, which he can exercise by deciding not to use an offeree representative. But that blackball loses its power if the shareholder does anything that would cause the issuer to believe that he has business acumen.

86 The basic limitation of proposed rule 146 is 35 purchasers, see note 72 supra, but in the case of business combinations, up to 35 acquired-corporation shareholders are excluded from the count. Proposed SEC Rule 146(g)(3)(ii)(f), 38 Fed. Reg. 28959 (1973).

87 Exclusions which might be applicable in the case of X Corporation include those for any shareholder who is a spouse or close family member of another X shareholder, for any trust in which a shareholder or his family members own all the beneficial interest, and for any officer or director of the issuer, Y. Proposed SEC Rules 146(g)(1)(i)(a), (b), (3)(ii)(b), 38 Fed. Reg. 28958 (1973).
146 will provide a concrete means for issuers seeking to acquire small public corporations to escape the gunjumping problem. The rule is not without its difficulties, however, perhaps the greatest of which concerns the offeree representative concept. To be an offeree representative a person must, *inter alia*, have "such knowledge and experience in financial and business matters that he is capable of evaluating the risks of the prospective investment . . .". Perhaps a group of professional offeree representatives will be established, but it appears that the Commission is to some extent relying on the dominant shareholders in the acquired corporation to perform this representative role. Even if some of these shareholders are willing to assume this agency obligation while negotiating with the issuer, in many cases there will be no one within the acquired corporation who is qualified to act as offeree representative for other shareholders.

As the proposed rule is presently drafted, the problem of offeree representation is aggravated because, unlike the standard imposed upon the issuer for assessing the offeree's expertise, reasonable grounds to believe that the representative qualifies are not sufficient. By definition, a person cannot qualify as an offeree representative unless he does in fact possess the necessary business acumen. If the offeree's representative does not actually have such

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89 Schneider & Manko, *supra* note 5, at 993.
90 For a discussion of the reasons why majority shareholders may be unwilling to accept this agency relationship, see *id*.
91 *Id*.

92 Even under the "reasonable grounds" test placing the burden upon the issuer creates some problems. The rule provides that the issuer must have reasonable grounds to believe that the nature of the offerees satisfies the rule 146(d) requirements "prior to making an offer" (emphasis added). The rule does not explain how the issuer can have reasonable grounds for an opinion on prospective offerees without "attempting to dispose" of its securities. *Cf.* Schneider & Manko, *supra* note 5, at 993; SEC Securities Act Release No. 285 (Jan. 24, 1935). The process of acquiring "reasonable grounds" would probably entail "attempting to dispose" of securities unless the issuer has no duty to investigate and can rely on a lack of unfavorable knowledge. However, it is arguable that such a duty was intended. First, the language of the rule, "[t]he issuer . . . shall have reasonable grounds to believe" (emphasis added), seems to indicate that the issuer has an affirmative duty. This language should be contrasted with the reference in subparagraph (h)(1) of the rule to "making reasonable inquiry" and the phrasing used in the section 11 due diligence defenses, Securities Act §§ 11(b)(3)(A)-(D), 15 U.S.C. §§ 77k(b)(3)(A)-(D) (1970), which either expressly provide for "reasonable investigation," or imply that no affirmative duty is imposed through the phrase, "no reasonable ground to believe and did not believe." *See* 3 LOSS 1727. Second, if the issuer could satisfy rule 146(d) by doing nothing so long as it had no unfavorable knowledge about a prospective offeree, the policy underlying proposed rule 146 and section 4(2) precedent would not be served; the issuer would be safest where it knew nothing about the offerees.
knowledge and experience, the rule 146 exemption will be lost even if the issuer has reasonable grounds to believe that he does qualify.\footnote{The language of proposed rule 146(d) ("The issuer . . . shall have reasonable grounds to believe . . . (1) that either the offeree or his offeree representative has, or both together have, [the necessary experience in business and financial matters]") implies that a reasonable belief in the representative’s qualifications is sufficient. But the definitional criteria for "offeree representative," set forth in proposed rule 146(a) (1), contain no reasonable belief standards. Thus, when the offeree’s agent does not in fact possess the requisite knowledge and experience, the conditions in paragraph (d) will not be satisfied no matter how reasonable the issuer’s belief is concerning the agent’s qualifications, for the issuer’s belief must relate to one who already qualifies as an "offeree representative." Although this result may not have been intended by the SEC, the language of the rule seems to require it. And should the issuer make an offer to an unqualified agent, a not unlikely possibility since issuers apparently may make offers after they have the required "reasonable grounds to believe," this offer (along with any other offers which the issuer may have previously made) will violate section 5(c), since proposed rule 146 will be inapplicable.}

Thus, it appears that neither section 4(2) nor proposed rule 146 can solve all the problems of negotiation gunjumping. And even if the private-offering exemption is successfully used, the securities issued in the transaction will be subject to resale restrictions.\footnote{See notes 128-37 infra and accompanying text.}

3. Other Exemptions

Although most of the other Securities Act exemptions are clearly inapplicable to A, B, and C reorganizations, two deserve some comment. The intrastate exemption, Securities Act section 3(a)(11),\footnote{15 U.S.C. § 77c(a)(11) (1970) exempts: Any 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.} while available, will rarely be applicable to reorganizations. The acquiring corporation must take the acquired-corporation shareholders as it finds them and it will not often happen that all of the acquired corporation shareholders will be domiciliaries\footnote{See 1 Loss 598.} of the state where the acquiring corporation is incorporated and doing business.\footnote{The requirements of section 3(a)(11) are most likely to be met when the acquired corporation is closely held. If this section is available in such a situation, it, rather than section 4(2), may be used, and some of the problems inherent in the private-offering exemption can be circumvented. The SEC has recently proposed rule 147, which defines the terms and clarifies the conditions of section 3(a)(11), but will not affect the requirement that offerees be domiciliaries of the state where the issuer is resident and doing business. SEC Securities Act Release No. 5349 (Jan. 8, 1973).} The integration concept will prohibit any attempt to treat
sales to affiliates as a separate "issue" in applying section 3 (a) (11).98

The integration concept is not applied, however, to regulation A, the small-offering exemption,99 promulgated by the SEC pursuant to section 3(b) of the Securities Act.100 This exemption applies when the aggregate offering price does not exceed $500,000101 and apparently can be used to avoid negotiation gunjumping whenever the securities to be offered and sold to acquired-corporation affiliates do not exceed this amount. However, regulation A involves an abbreviated registration process102 and restricts offers prior to SEC clearance.103 Accordingly, regulation A does not present a totally realistic alternative, even if the price of the offered securities is within its limit.104

III. IF REGISTRATION IS REQUIRED 
DO THE NEGOTIATIONS VIOLATE SECTION 5(c)?

A. THE SEC'S SOLUTION — UNDERWRITER STATUS AND SECTION 2(3)

To alleviate the problems of prereorganization gunjumping, the SEC apparently treats the acquired-corporation shareholders who negotiate the deal as underwriters. Because section 2(3) excludes from the definitions of "sale," "offer to sell," and "offer to buy" preliminary negotiations or agreements between issuer and underwriter,105 the prereorganization discussions will not violate section


102 See SEC Rules 255-56, 17 C.F.R. § 230.255-256 (1973). The regulation A procedure is less expensive and time consuming than full registration. For example, the financial statements submitted pursuant to regulation A need not be certified.

103 SEC Rule 255(a), 17 C.F.R. § 230.255 (a) (1973); 1 LOSS 625-26.

104 The major advantage offered by regulation A is that, since a full registration statement is not required, there is no section 11 liability for either the issuer, or perhaps more importantly here, for acquired-corporation affiliates. Section 11 is discussed at notes 123-27 infra and accompanying text.


The [terms] "sale" or "sell" . . . "offer to sell," "offer for sale," or "offer" . . . and the term "offer to buy" as used in subsection (c) of section 5 shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer).
Although the SEC has never officially announced this position, Professor Loss has stated:

In the case of a share-for-share exchange between Corporations A and B when those in control of the corporation sought to be acquired (B) are cooperative, the SEC considers that they are "underwriters" on the theory that they are "selling for" the acquiring corporation, thus permitting discussions with the management under the "preliminary negotiations" clause of §2(3) before an offer is made to the shareholders generally.\(^{106}\)

The SEC's approach does not solve the prereorganization gun-jumping problems satisfactorily. Whether the liability and denial of investor protection accruing to underwriters under the Act are consistent with the role of the acquired-corporation negotiators in the reorganization is discussed in the second part of this section. But two threshold problems must be considered beforehand.

First, stretching the Act's definition of underwriter to encompass shareholders who negotiate for the acquired corporation is no simple task. By virtue of section 2(11) an underwriter is:

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\text{[a]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the}
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\(^{106}\) Loss 2562 (Supp. 1969) (citations omitted). Accord, Bromberg, supra note 30, at 812. Although Professor Loss mentions only B reorganizations, a recent no-action letter, American Hospital Supply Corp. (SEC June 4, 1973), suggests that the commission’s approach will be extended to A and C reorganizations as well now that rule 145 has become effective. In that letter the Commission stated that the execution of an agreement establishing, subject to shareholder approval, the rights of the parties in a C reorganization did not constitute a "sale" where affiliates of the corporation to be acquired joined in the execution of the agreement. But it added that any solicitation of an affiliate's proxy or his promise to vote his shares in a specific manner would be a sale or offer to sell and subject to section 5. That the Commission premised its decision on a view that the acquired-corporation affiliates are underwriters is indicated by its statement that section 2(3) excludes "preliminary negotiations between an issuer and an underwriter" and its subsequent reasoning that execution of the agreement was not a sale because it was "preliminary" to the submission of the agreement for shareholder approval. In using the word "preliminary" the Commission must have meant something more than occurring earlier in time, since clearly the transactions with the affiliates represent "attempts to dispose" and would violate 5(c) no matter when they occurred, so long as no registration statement has been filed. By "preliminary" then the Commission must have meant something else; it must have intended the word as a shorthand for its conclusion that the affiliates fell within the preliminary-negotiations-with-underwriters exception to section 2(3). This result makes the Commission's later statement that the solicitation of proxies from the affiliates would violate section 5 rather puzzling. If the affiliates are to be considered underwriters, then even a firm contract to exchange their shares for those of the issuer would not be treated as a section 2(3) "sale." See 2 Loss 213.
usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.\textsuperscript{107}

As described by Professor Loss, the SEC's tack is to apply the "'underwriter' label to those "'in control'"\textsuperscript{108} of the corporation to be acquired — in other words, the "'affiliates'" of that corporation\textsuperscript{109} — for purposes of section 2(3). But the statutory definition of an underwriter in section 2(11) says nothing about affiliate status; one becomes an underwriter only by engaging in the specified affirmative activity — purchasing from an issuer with a view to, or selling for an issuer in connection with, a distribution, or participating in such a transaction. Mere status is insignificant, especially status within a corporation other than the issuing corporation. The SEC overcomes this conceptual hurdle by indulging in what amounts to a conclusive presumption that acquired-corporation affiliates who are "'cooperative'" in the early reorganization negotiations will end up "'selling for'" the acquiring corporation if an agreement is reached. Affiliate status is critical to the presumption because the Commission apparently assumes it will be those in control of the acquired corporation who will promote the sale of acquiring-corporation securities to their fellow shareholders. It is certainly questionable whether the likelihood that controlling shareholders of the acquired corporation will ultimately "'sell for'" the acquiring corporation warrants viewing them as underwriters of the entire issue at the time negotiations begin, and, as a result, denying them the treatment accorded ordinary investors without any reference to their possible intent to hold for investment the securities they actually receive in the reorganization.\textsuperscript{110}

\textsuperscript{108} The Securities Act does not define "'control,'" but the SEC has done so by rule. "'The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." SEC Rule 405(f), 17 C.F.R. § 230.405(f) (1973).
\textsuperscript{109} "'Affiliate'" is defined by the SEC as any person who directly or indirectly "'controls, or is controlled by, or is under common control with, the person specified.'" SEC Rule 405(a), 17 C.F.R. § 230.405(a) (1973). When used in this Note, unless otherwise noted, "'affiliate'" means only a person who controls — the first part of the SEC's definition.
\textsuperscript{110} When an ordinary investor purchases securities from an issuer, there is a "'sale'" and the issuer is subject to the prohibitions of section 5. The purchase half of the purchase-sale transaction and, when the investor resells the securities, the sale
The second flaw in the SEC's approach is that the underwriter exception will not always cover all of the negotiators. Consequently, the Commission's solution does not save all prereorganization negotiations from gunjumping problems, and it does not provide the acquiring corporation with a reliable means of determining when it is risking a Securities Act violation. Some examples drawn

half of the resale transaction are usually exempt under Securities Act § 4(1), 15 U.S.C. § 77d(1) (1970), which exempts "transactions by any person other than an issuer, underwriter or dealer." See 1 Loss 182-84, 641-44. However, if the investor has purchased "with a view to distribution" he will be an underwriter; the section 4(1) exemption will be unavailable, and, because section 2(3) excepts contracts between the issuer and an underwriter from the definition of "sale," see id. at 213, the issuer will not be governed by section 5. A thorough discussion of the "distribution" concept, crucial to the ordinary investor-underwriter distinction, is beyond the scope of this Note. Briefly, a distribution basically requires a "public offering," see id. at 551, and the question of when a distribution has ended is answered, at least in part, by whether the securities have come to rest in reasonably small quantities in the hands of ordinary investors.

The problem with the Commission's approach is that insofar as it uses the "selling for" branch of the underwriter definition to secure a section 2(3) exception for acquired-corporation affiliates, these shareholders are deprived of ordinary-investor treatment in all cases. It is entirely possible that although the affiliates of the acquired corporation do in fact sell for the acquiring corporation by encouraging other acquired-corporation shareholders to approve the transaction, they will intend to hold the securities they receive in the transaction for investment, that is, they will not purchase "with a view to distribution." But because they are considered "selling for" underwriters as to the entire issue, their intent as to the securities they actually receive will be irrelevant.

It should be noted, however, that in stating the SEC approach to negotiation gunjumping, Professor Loss is less than clear on this problem. After setting forth the "selling for" basis for applying the section 2(3) exception, see text accompanying note 106 supra, he continues:

[T]his means that when there is a registration statement, either because B [the acquired corporation] is publicly held or because some of the large B stockholders take A [acquiring corporation] stock for distribution, there is a problem of specifying those stockholders as underwriters in the registration statement. This is easy enough when they are going to resell right away. Otherwise the Commission is apt to ask for an undertaking to file a post-effective amendment or a new registration statement before any distribution that would make them underwriters — though they might always demonstrate that they had held the shares long enough so that they had lost an underwriter's status.

4 Loss 2562 (Supp. 1969) (emphasis added). It is not logical that a "selling for" underwriter can lose that status by holding the securities for any length of time. Perhaps this inconsistency can be reconciled, however, if the large B stockholders who take for distribution in Professor Loss's example are not affiliates of B and therefore do not fall within the "selling for" branch of the section 2(11) definition of "underwriter." But see note 112 infra.

Under the "selling for" branch of section 2(11), an affiliate can, of course, lose underwriter status by no longer being in a position where the SEC can view him as presumptively acting on behalf of the issuer. In other words, the underwriter taint "wears off" simply by his no longer being a "seller for" the issuer. Thus, after the reorganization is consumated the affiliate can claim that his "selling for" activities have ceased, and, absent any arguments that he is an underwriter under the "purchase form" branch of section 2(11), he can claim total immunity from underwriter status. This result would allow him to sell his own securities freely.
from the hypothetical discussed earlier will demonstrate the various problem areas.

The nonaffiliate negotiator. — The SEC's position is to extend underwriter status only to those in control of the acquired corporation. Since "control" under the Securities Act is an imprecise concept, however, the acquiring corporation may inadvertently jump the gun by negotiating with a person who turns out not to be an affiliate of the acquired corporation and who consequently will not be deemed an underwriter for purposes of the section 2(3) exception. Avoidance of gunjumping by excluding nonaffiliates from the negotiations requires an understanding by the acquiring corporation of the determinants of control, a correct assessment of the status of the individuals involved, and a willingness on the part of these individuals to be excluded at the acquiring corporation's request.

Affiliate status depends on the entire situation within the corporation. Single factors such as shareholdings and management positions, while important, are not determinative.

Ultimately the test is briefly stated: taking into account history, family, business affiliations, shareholdings, position and all other circumstances, what person or what group calls the day-to-day shots? The shots in major matters? What person or what group could, if it wished, call the shots? When these are identified the controlling persons and the controlling group are identified.

In the hypothetical, Y Corporation's biggest worry regarding affiliate status involves $E$. Since $E$ owns only 3 percent of $X$'s

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112 Majority stock ownership is not required for an individual to be a controlling person. H.R. Rep. No. 85, 73d Cong., 1st Sess. 14 (1933); Thompson Ross Sec. Co., 6 S.E.C. 1111, 1119 (1940). Indeed, much less may suffice. It has been noted that ownership of 10 percent of a corporation's shares may raise a rebuttable presumption of control, especially if the shareholder has other attributes of control as well. Sommer, supra note 111, at 568. Cf. Schneider & Manko, supra note 5, at 997.

113 Although merely being an officer or a director does not make one a controlling person, it raises a presumption to this effect. Sommer, supra note 111, at 576-77; see 2 Loss 781.


115 Sommer, supra note 111, at 582.

116 There are other problems as well. Although $B$'s 15-percent ownership may be sufficient to make him an affiliate, see note 112 supra, he may not be, because he takes no part in the conduct of the business of $X$ Corporation. See Hexagon Laboratories, Inc., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. § 78,497 (SEC 1971). But see Sommer, supra note 111, at 564. Of course, as $A$'s father and a member of the family that controls 60 percent of $X$ and fills most of its
shares and is not part of X's management, the only way in which he might be deemed a controlling person is through his membership in a controlling group by virtue of his family ties,\textsuperscript{117} and it is not clear whether that alone is enough. It would probably be sufficient if the family needs E to exercise control and E votes with the group. But family membership will mean little if E is inactive or usually out of step with a family that controls the corporation without his vote.\textsuperscript{118} Thus E's status as an affiliate probably depends most of all upon the relationships among the various family members\textsuperscript{119} — matters which are difficult for Y Corporation to assess when it initiates the discussions. Since E wants to be present at the negotiations to voice his doubts about the proposed reorganization, Y is in a perilous position. If the negotiations are held with E present, and if E dislikes the outcome, he can allege and possibly prove that the gun was jumped as to himself since he is not an affiliate of X and therefore cannot be included as an underwriter under the SEC approach.

The noncooperative affiliate negotiator. — In addition to being affiliates, the acquired corporation's negotiators must be "cooperative" in order for the section 2(3) exception to apply. C and E present a problem in this respect since they are troubled by the family giving up control of X. There is no way Y can ensure that they will not oppose the transaction, even if Y is aware of their doubts.\textsuperscript{120}

management positions, he may be a controlling person by virtue of being a member of the controlling group. See notes 117-19 infra and accompanying text.

Since D is both a 5-percent owner and a director, as well as a family member, there is little possibility of his not being an affiliate. See Sommer, supra note 111, at 569. F's only attribute of control is his management position, which may not alone make him an affiliate, but since he is an employee, he may be an affiliate in the sense that he is "controlled by" X. See Schneider & Manko, supra note 35, at 817 & n.42. But see note 118 infra.

\textsuperscript{117} See 2 Loss 779-80 & n.37.

\textsuperscript{118} Sommer, supra note 111, at 580. If by virtue of A's "calling the day-to-day shots" he is deemed to be in control of X, either alone or together with his father, B, then there may be no controlling group, and no one else could be a controlling person. See id. at 575. On the other hand, if the family is considered the controlling group, perhaps nonfamily members like F would not be controlling persons. See id. at 582.

\textsuperscript{119} See SEC v. Micro-Moisture Controls, Inc., 148 F. Supp. 558 (S.D.N.Y. 1957), aff'd sub nom. SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959); Strathmore Sec., Inc., SEC Securities Exchange Act Release No. 8207 (Dec. 13, 1967). However, the ultimate issue is whether acquired corporation shareholders are "selling for" the acquiring corporation. Merely being a member of a control group should not be sufficient control to show that the member was "selling for" the acquiring corporation though it might indicate control for other purposes, such as determining when a sale is a secondary distribution subject to registration.

\textsuperscript{120} If Y enters the negotiations blind, not knowing X management's feelings
If C and E oppose the transaction, they cannot be deemed to be underwriters on the theory that they are “selling for” Y, for they are certainly not promoting the reorganization to the public shareholders of X. Furthermore, it may be argued that affiliates of X who oppose the reorganization cease to be affiliates by breaking away from the control group, and thus preclude the application of the section 2(3) exception for this reason as well. \textsuperscript{121}

The passive affiliate. — Since the use of the section 2(3) exception is based on the theory that cooperative affiliates of X are underwriters because they sell for Y, another problem is presented by persons such as B, who are not uncooperative but play no active role in the negotiations. The question is what amount of affirmative conduct, if any, is required at the negotiations stage to trigger the “selling for” presumption? Clearly those affiliates who encourage the negotiations and advocate the proposed reorganization are “cooperative.” But what of affiliates who merely allow the negotiations to continue without objection? These questions cannot readily be answered. The only alleviation is that if the affiliate is entirely passive and the acquiring corporation does not need his approval, \textsuperscript{122} the problem is mooted; the acquiring corporation can ignore him, and the gun will not be jumped as to him.

In summary, although prereorganization negotiations do not per se jump the gun under the analysis presently applied by the SEC, acquiring corporations must currently overcome several potential problems — some of which may be virtually insurmountable — to bring all of the prospective acquired corporation’s negotiators under the aegis of the section 2(3) exception.

B. Effects of Underwriter Status

1. Section 11 Liability

By being termed underwriters rather than ordinary investors, X Corporation’s cooperative affiliates will be subjected to various additional burdens and liabilities under the Securities Act, not the least of which is civil liability under section 11 for deficiencies in the

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\textsuperscript{121} Cf. Schneider & Manko, supra note 32, at 817-18.

\textsuperscript{122} Chances are, however, that the acquiring corporation will not be able to ignore an affiliate, because it may need either his management vote or, if the affiliate is a substantial shareholder, an indication of his interest in the reorganization.
registration statement.\textsuperscript{128} Although section 11 gives underwriters several defenses,\textsuperscript{124} it contains no privity requirement and therefore creates a great number of potential plaintiffs to whom underwriters may be liable.\textsuperscript{125}

To hold acquired-corporation affiliates liable for omissions and misrepresentations contained in a registration statement prepared by the acquiring corporation is somewhat extraordinary.\textsuperscript{126} Since such liability is one of the results of underwriter status, any evaluation of the SEC approach to solving the negotiation gunjumping problem must include an analysis of the merits of imposing such liability on acquired-corporation affiliates.\textsuperscript{127}

2. Resale Restrictions

Underwriters may not freely resell unregistered securities they have purchased.\textsuperscript{128} They must have the original issuer register the securities\textsuperscript{129} try to find another applicable exemption, or attempt to qualify their sales under SEC Rule 144.\textsuperscript{130} Rule 144 sets forth conditions under which the sale of securities will not be deemed to be a distribution and the sellers, therefore, not underwriters. First, there must be "available adequate current public information with respect to the issuer of the securities."\textsuperscript{131} Second, if the securities are "restricted,"\textsuperscript{132} they must have been held for at least two years prior to the sale.\textsuperscript{133} Third, the amount of secu-

\textsuperscript{129} Id. §§ 77k(b)-(c).
\textsuperscript{125} 3 Loss 1731.
\textsuperscript{127} See notes 165-70 infra and accompanying text.
\textsuperscript{130} 17 C.F.R. § 230.144 (1973).
\textsuperscript{131} SEC Rule 144(c). For an interpretation of this requirement, see SEC Securities Act Release No. 5306 (Sept. 26, 1972).
\textsuperscript{132} "Restricted securities" are securities acquired "in a transaction or chain of transactions not involving any public offering." SEC Rule 144(a) (3).
erties sold must fall within the limits of the rule. Finally the sales must be made in "brokers' transactions."

Even if these requirements are met, however, rule 144 may not apply, since it is only available to affiliates of the issuer and sellers of restricted securities. Therefore, in a public offering, persons such as the acquired corporation's affiliates in the hypothetical who are deemed to be underwriters for purposes of the section 2(3) exception, but who are not affiliates of the issuer will be unable to "leak" the securities they receive under rule 144.

3. Underwriters and Securities Act Protection

Since the purpose of the Securities Act is to protect the public, some courts have stated in dictum that underwriters, as participants in the distribution process, are not entitled to the Act's protection. Whether or not such dicta are correct, the use of the section 2(3) exception creates a situation where acquired-corporation affiliates may find it difficult to sue the acquiring corporation.

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136 SEC Rule 144(b), 17 C.F.R. § 230.144(b) (1973):
Any affiliate or other person who sells restricted securities of an issuer for his own account, or any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof within the meaning of section 2(11) of the Act if all the conditions of this rule are met.
138 S. REP. NO. 47, 73d Cong., 1st Sess. 6-7 (1933); H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933).
139 In Athas v. Day, 186 F. Supp. 385 (D. Colo. 1960), after holding that the plaintiff's suit was barred by the statute of limitations, the court noted that the plaintiff was an underwriter "and as such is not entitled to the protection of the Act . . . . The Act does not protect those who are engaged in steps necessary to the distribution of securities issues." Id. at 389. Similarly, in Slack v. Stiner, 358 F.2d 65 (5th Cir. 1966), after holding that the original plaintiffs' suit was not a class action which tolled the statute of limitations for plaintiffs added later, the court continued: There is another reason why, in our opinion, the added claimants cannot recover . . . . [The original] action could be maintained by the original plaintiffs as a class suit only if they were members of the class they sought to represent. The cause of action under the Securities Act is given to those purchasers who are not underwriters or dealers. [The original plaintiffs] being underwriters or dealers are not members of the class entitled to recover and hence they cannot maintain a class action.
Id. at 70.
140 See 3 Loss 1723 n.129.
Securities Act section 12 expressly provides for recovery for violations of section 5\textsuperscript{141} and for misrepresentations made in offering or selling securities.\textsuperscript{142} The implied private right of action under SEC Rule 10b-5\textsuperscript{143} similarly provides a remedy for fraud "in connection with the purchase or sale of any security."\textsuperscript{144} Finally, section 11 provides relief for injury from omissions or misrepresentations in registration statements.\textsuperscript{145} All of these remedial provisions require that the plaintiff be a "purchaser."\textsuperscript{146} If the section 2(3) exception applies, however, by definition there is neither an offer nor a sale, and presumably without a sale, there could be no purchase.\textsuperscript{147} Thus, in order for the affiliates of the acquired corporation to assert any Securities Act cause of action against the acquiring corporation, it will be necessary to resort to a troublesome "purchase without a sale" fiction.\textsuperscript{148}

In summary, as a result of being deemed underwriters, acquired-corporation affiliates (1) will be subject to section 11 liability for

\textsuperscript{142}Id. § 12(2), 15 U.S.C. § 77l(2).
\textsuperscript{144}17 C.F.R. § 240.10b-5 (1973), promulgated pursuant to Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1970). The implied private right under Securities Act section 17(a) is substantially the same as that under rule 10b-5, except that it applies to defrauded purchasers only. For a discussion of the similarities between rule 10b-5 and section 17(a), see Note, The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5, 24 CASE W. RES. L. REV. 363, 371 n.41 (1973).
\textsuperscript{145}See notes 123-25 supra and accompanying text.
\textsuperscript{146}Section 12 provides that anyone who violates its provisions "shall be liable to the person purchasing such security from him . . . ." The words "in connection with the purchase or sale of any security" in rule 10b-5 have been interpreted as requiring that the plaintiff be a purchaser or a seller. Birnbaum v. Newport Steel Corp., 193 F. Supp. 164 (S.D.N.Y. 1968), cert. denied, 343 U.S. 956 (1952). And although section 11 has broadened the class of potential plaintiffs by not requiring privity, it still limits recovery to "any person acquiring such security," which in effect requires that one be a purchaser. See 3 Loss 1731.
\textsuperscript{147}The Securities Act does not define "purchase." It "presumably is complementary to the word [sale]." 1 Loss 548. But see Fidelis Corp. v. Litton Indus., Inc., 293 F. Supp. 164 (S.D.N.Y. 1968), there the court held on the one hand that the issuance of the defendant-acquiring corporation's stock was exempt under rule 133, which exempted certain reorganizations as not involving a sale. Id. at 168. But on the other hand, it denied a motion, based on the ground that the plaintiffs were not purchasers, to dismiss the plaintiffs' claims under sections 12(2) and 17(a) and rule 10b-5. Id. at 169-70. It should be noted, however, that the rule 133 "no sale" provision applied only to section 5, so there could have been a sale in a rule 133 transaction for the purpose of applying the antifraud provisions.
\textsuperscript{148}See 1 Loss 533. Even if there has been no Securities Act "sale," there may still have been a sale for Exchange Act purposes, since the Exchange Act definition of sale, § 3(a)(14), 15 U.S.C. § 78c(a)(14) (1970), does not contain any exceptions.
deficiencies in registration statements prepared by the acquiring corporation, (2) may be unable to resell freely the securities they receive in the reorganization, and (3) even if the protections of the Securities Act are available despite their underwriter status, will have to assert successfully the existence of a purchase without a sale in order to succeed in a suit against the acquiring corporation. In order to fully assess the impact of the use of the section 2(3) exception to allow prereorganization negotiations and the resultant disabilities placed upon acquired-corporation affiliates, however, it is necessary to analyze the effect of postreorganization events on those affiliates.

C. Postreorganization Events and Underwriter Status

1. A and C Reorganizations: Rule 145(c)

Rule 145, which provides that a reorganization requiring shareholder approval involves a Securities Act section 2(3) offer, defines "underwriter" as follows:

[A]ny party to any [reorganization specified in the rule], other than the issuer, or any person who is an affiliate of such party at the time any such transaction is submitted for vote or consent, who publicly offers or sells securities of the issuer acquired in connection with any such transaction, shall be deemed to be engaged in a distribution and therefore to be an underwriter thereof within the meaning of Section 2(11) of the Act.¹⁴⁰

This provision clearly applies to affiliates of the acquired corporation.¹⁵⁰ It applies to them the "purchased from with a view to distribution" branch of the section 2(11) underwriter definition, and it does so with a vengeance. While an ordinary purchaser can escape inclusion under this branch of section 2(11) by showing an intent to hold the securities for investment,¹⁵¹ rule 145(c) affords no such defense.¹⁵² It requires only that a person (1) be an affiliate and (2) offer or sell the securities obtained in the rule 145 transaction to the public.¹⁵³ Thus unlike the section 2(11) underwriter who can refute underwriter status by holding his securities...

¹⁴⁰ SEC Rule 145(c), 17 C.F.R. § 230.145(c) (1973).
¹⁵⁰ Schneider & Manko, supra note 32, at 817 n.40.
¹⁵¹ See note 110 supra and accompanying text. This and other defenses to underwriter status were available under rule 133(c), which defined underwriter in the same terms as section 2(11).
¹⁵³ It can perhaps be argued that the investment intent defense is implicit in the second rule 145(c) requirement. But see notes 154-55 infra and accompanying text.
long enough to demonstrate an investment intent, an acquired-corporation affiliate remains a potential rule 145(c) underwriter for as long as he owns the stock and becomes an actual underwriter automatically once he sells his shares to the public. Further, since rule 145(c) is not the exclusive means of obtaining underwriter status, an acquired-corporation affiliate who does not resell to the public, and is therefore not a rule 145(c) underwriter, may nevertheless be a section 2(11) underwriter if he did not have the requisite investment intent when he received his securities or if he gets caught in the "selling for" underwriter net, either because he actually solicits on behalf of the issuer or because he is deemed to have done so under the SEC's fiction discussed above.

Rule 145(c), therefore, undercuts many of the arguments against the use of the section 2(3) exception. Since affiliates of the acquired corporation will be deemed underwriters under rule 145(c) once they offer their shares to the public, it is not entirely unpalatable to deem them underwriters during the prereorganization stage in order to apply the section 2(3) exception. And the SEC's presumptive use of the section 2(3) exception, because it is based on the "selling for" branch of section 2(11) which negates the investment-intent defense to underwriter status, is also less objectionable than it might be without rule 145(c), since this defense is equally unavailable under the rule.

There is an important difference, however, between being deemed an underwriter for section 2(3) purposes and being deemed one pursuant to rule 145(c). Under rule 145(c), underwriter status will attach to an acquired-corporation affiliate at a much later date, and perhaps may never attach at all. This distinction may affect the existence of resale restrictions. However, for

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154 See 1 Loss 551-52, 665-73.
155 Schneider & Manko, supra note 5, at 998-99; Note, supra note 152, at 957.
156 Schneider & Manko, supra note 32, at 818.
157 Section 2(11) underwriter status will still be burdensome to acquired-corporation affiliates who do not resell the securities they receive in the reorganization, since under rule 145(c) they would not be underwriters.
158 See note 110 supra and accompanying text.
159 This is not to say, however, that the lack of defenses is any more justifiable under rule 145(c) than under the use of the section 2(3) exception.
160 Under the SEC approach, in order for section 2(3) to except all prereorganization negotiations, acquired-corporation affiliates must be underwriters at the time negotiations begin. Rule 145(c), on the other hand, does not make the affiliate an underwriter until he sells to the public the shares he received in the reorganization, a transaction which, if it occurs at all, will occur after the reorganization has been consummated.
161 See note 110 supra, especially the fourth paragraph thereof, and notes 182 and
purposes of section 11 liability, while it will have an impact on when an affiliate becomes subject to suit; the difference will not alter the substance of the liability. No matter when underwriter status attaches, the affiliate will be deemed to be an underwriter with respect to the securities exchanged in the reorganization at the time the registration statement was filed and will therefore be liable for any omissions or misrepresentations it contains. But the difference in theories of underwriter status will have a significant effect upon the investor protection which affiliates receive under the securities acts. Because rule 145(c) does not make affiliates underwriters until they decide to sell their shares, they may retain their antifraud and section 12(1) remedies as long as they deem necessary.

While being treated as a rule 145(c) underwriter may not be as onerous as being treated as one pursuant to the SEC's section 2(3) approach, there remain substantial problems with the rule's

183 infra and accompanying text. There is some justification for burdening acquired-corporation affiliates with restrictions on the resale of the securities they receive in the reorganization, since any prereorganization sale by these affiliates of their shares in the acquired corporation would probably have been a secondary distribution requiring registration. As controlling persons they would be deemed "issuers" for purposes of section 2(11), and their broker or dealer would be a section 2(11) underwriter because he "sells for" or "purchases from" an "issuer." See 1 Loss 700-06. Since restrictions would attend the sale of their acquired-corporation shares, it is not unfair to extend these restrictions to a sale of the acquiring-corporation shares they received in exchange. In both situations rule 144 will be available. See notes 171-72 infra and accompanying text.

162 By holding the securities they receive for a sufficient period, acquired-corporation affiliates may be able to shield themselves from suit until the statute of limitations has run. If the reorganization exchange represents a bona fide offering to the public, any section 11 action not commenced within three years will be barred. Securities Act § 13, 15 U.S.C. § 77m (1970).

163 In setting forth its reasons for adopting rule 145(c), the SEC stated: "[F]rom a practical standpoint, because [acquired-corporation affiliates] usually are in a position to verify the accuracy of information set forth in the registration statement, and usually are in a position to influence the transaction, the Commission believes that this provision is not unreasonably burdensome." SEC Securities Act Release No. 5316, pt. II.D (Oct. 6, 1972). This indicates the Commission's belief that, once deemed an underwriter, an affiliate will be treated as if he were an underwriter at the time the registration statement was filed.

164 Once the affiliates become underwriters, their dealings with the acquiring corporation will no longer be deemed to be "offers" or "sales." As a result, relief under sections 11, 12(1), and 12(2) of the Securities Act and rule 10b-5 may become unavailable. See notes 138-48 supra and accompanying text. Foregoing relief under section 12(1) is in the interest of both corporations, since it allows negotiations for the reorganization. See notes 20-26 supra and accompanying text. But during the prereorganization period, the affiliates have a compelling need for antifraud protection. Yet since both section 12(1) and the antifraud provisions require a purchaser it would be difficult conceptually to reconcile denying affiliates the former remedy while providing them the latter.
scheme of calling an underwriter every acquired-corporation affiliate who resells his securities to the public.

a. Section 11 Liability.— Being an underwriter subjects affiliates of the acquired corporation to section 11 liability, including liability for statements prepared by the acquiring corporation in a reorganization. The SEC has asserted that because acquired-corporation affiliates are typically in a position to verify these statements, this liability should not prove "unreasonably burdensome." Not all commentators have agreed, however. Being affiliates of the acquired corporation in reality may give little, if any, ability to determine the truth of registration statements concerning the acquiring corporation, or to influence the content of the statements. Accordingly, it is questionable whether affiliates of the acquired corporation should be included among the persons who must investigate and make certain that the registration statement is accurate. Therefore, the imposition of section 11 liability, even in light of the available defenses and the possibility of indemnification, seems overly harsh.

b. Resale Restrictions: Rule 145(d).— Rule 145(d) permits persons who would otherwise be rule 145(c) underwriters to "leak" the securities acquired in the rule 145 transaction in accordance with rule 144. Although from the underwriter's point of view this is not a totally acceptable solution since he would prefer to be able to resell freely, it is probably better in most cases than

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165 See notes 123-27 supra and accompanying text.
166 See note 163 supra. Rule 145(c) as originally proposed based underwriter status on the amount of securities received in the rule 145 transaction in relation to the total outstanding amount of acquiring-corporation securities of the same class. SEC Securities Act Release No. 5246 (May 2, 1972). However, this test, which would have helped to assure that the acquired-corporation shareholder was in a position to influence the transaction, was abandoned after adverse public comments. SEC Securities Act Release No. 5316, pt. II.B.2 (Oct. 6, 1972).
167 See Note, supra note 152, at 954-61.
168 See text accompanying note 19 supra.
169 See note 122 supra and accompanying text.
170 Of course there is nothing wrong with holding acquired-corporation affiliates accountable for statements concerning and originating from the acquired corporation. The corollary is that it seems unfair to hold the acquiring corporation liable for violations based on these statements. See Schneider & Manko, supra note 32, at 824-25.
172 Such persons would not be able to use rule 144 absent this express authorization. See notes 136-37 supra and accompanying text. Rule 145(d) only requires that rules 144(c), (e)-(g) be followed, that is, the rule 144(d) holding period be inapplicable.
having to register the securities before they are resold.\textsuperscript{173} In the reorganization context, however, rule 144 presents some important problems.

First, the rule 144 procedure may not be used unless "adequate current public information with respect to" the acquiring corporation is available.\textsuperscript{174} If the acquiring corporation is a reporting company under the Exchange Act\textsuperscript{175} and its filings are up to date, there will be no problem;\textsuperscript{176} otherwise there may be.\textsuperscript{177}

Second, the provisions of rule 144 which require aggregating securities in determining the amount of securities that may be sold pursuant to the rule pose a further problem. Aggregation may be required in two ways:\textsuperscript{178} (1) rule 144(a)(2) has the effect of aggregating sales of securities by an individual and certain related individuals and entities by deeming them to be one "person" for the purpose of the rule;\textsuperscript{179} and (2) rule 144(e)(3)(vi) expressly aggregates sales by persons who "agree to act in concert for the purpose of selling securities of an issuer." Therefore, affiliates of the acquired corporation must be careful to avoid acting in concert, if it is possible to do so.\textsuperscript{180}

Furthermore, by conclusively treating every acquired-corporation affiliate, regardless of the amount of acquiring-corporation securities he receives or resells, as an underwriter, rule 145(c) produces practical problems not present under the use of the section 2(3) exception.\textsuperscript{181}

\textsuperscript{173} This statement assumes, of course, that an exemption from registration is not available and that the underwriter has no need to sell more than the relatively small amount permitted by rule 144.

\textsuperscript{174} SEC Rule 144(c), 17 C.F.R. § 230.144(c) (1973).


\textsuperscript{176} SEC Rule 144(c)(1), 17 C.F.R. § 230.144(c)(1) (1973).

\textsuperscript{177} SEC Rule 144(c)(2) provides that rule 144 will be available where the issuer is not a reporting company if certain information about it is "publicly available." Query what constitutes public availability? See SEC Securities Act Release No. 5306, pt. VI.B. (Sept. 26, 1972).


\textsuperscript{179} Rule 144(a)(2) "person" aggregation is expressly carried over to rule 145 via rule 145(e), which uses the rule 144(a)(2) definition of "person" for the purposes of rules 145(c)-(d). As a result of rule 144(a)(2), family members A and B in the reorganization hypothetical would have to aggregate their sales if they shared the same home.


\textsuperscript{181} See Note, supra note 152, at 941-42, 957; notes 105-06 supra and accompanying text. In addition to creating practical difficulties, the rule 145(c) approach raises
securities an affiliate of the acquired corporation receives, because of rule 145(c) he cannot freely resell them to the public. The SEC’s application of the 2(3) exception, on the other hand, is an informal administrative device, and the possibility does exist of deeming acquired-corporation affiliates to be underwriters for some, but not all, purposes. Moreover, it could be argued that although cooperative acquired-corporation affiliates are deemed to be underwriters temporarily during the negotiations, they are not necessarily underwriters as to the securities they receive in the reorganization unless there was a view to a “distribution” of these securities beyond the affiliates. While such solutions would eliminate one of the problems caused by deeming acquired-corporation affiliates under-

conceptual problems as well. The SEC’s traditional approach for section 2(3) purposes has been to use the “sells for . . . in connection with . . . distribution” branch of the section 2(11) underwriter definition. See text accompanying note 110 supra. Under this theory, the reorganization exchange itself can serve as the necessary “distribution.” But rule 145(c), by focusing on the affiliates’ resale of their own securities instead of on their initial activities in promoting the reorganization, appears to be utilizing the “purchased from . . . with a view to” branch. The distribution must therefore be found in the resale. This means that when an acquired-corporation affiliate receives only a small amount of acquiring-corporation securities in connection with a reorganization, his resale of these securities to the public is nonetheless deemed to be a distribution, even though it looks like an ordinary trading transaction. This result is difficult to reconcile with the SEC’s position in Alco Standard Corp., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. § 79,113 (SEC 1972). In Alco the Division of Corporate Finance of the SEC stated it would not recommend any action where the three shareholders and controlling persons of the acquired corporation, who did not become affiliates of the acquiring corporation, resold the small amount of securities they received in the B reorganization without registering them. The SEC apparently believed that there was no distribution beyond the acquired-corporation affiliates. In other words, when a B reorganization is involved, not all later sales to the public will be deemed to be distributions. The distribution concept is discussed further at note 110 supra.

182 See Schief & Sipple, The Corporate “Spin-Off” Device: Securities Act and Exchange Act Considerations, 16 How. L.J. 719, 734 (1971). The SEC’s interpretive technique makes it possible to assume that cooperative affiliates, although underwriters for the purpose of absolving the issuer from the gunjumping problem, are not underwriters for the purpose of depriving them of the right to resell their securities without need for registration or exemption. Since rule 145 is directed specifically at resale limitations, it admits of no such contextual variation.

183 To adopt this approach the Commission must say that: (1) with respect to securities received by other acquired-corporation shareholders, the affiliates are “selling for” underwriters and become underwriters as soon as the negotiations begin, but (2) with respect to the securities they themselves receive, the affiliates are to be treated only as “purchase from” underwriters and do not become underwriters unless they had a view to selling their securities in a transaction that constitutes a “distribution.” This approach could be justified on the theory that the originally presumed “selling for” posture of the affiliate (with respect to both his own securities and the securities sold to his fellow security holders) wanes as the reorganization period passes, leaving the “purchase from” branch of section 2(11) as the only method for establishing underwriter status. This theory is at odds with the view of “distribution” underlying rule 145(c). See note 160 supra.
writers, they require a rather complex construction of the underwriter definition in the statute in order to make it match precisely the interplay of conflicting administrative policies cutting for and against underwriter status. As a result, the potential for arbitrariness and uncertainty in determining when an affiliate is an underwriter would be increased. And these approaches would do nothing to solve the problems caused by the across-the-board sweep of rule 145(c).

In summary, although acquired corporation affiliates in A and C reorganizations will now be deemed to be underwriters under rule 145(c), this rule does not eliminate the need to resolve the problems created by presumptively calling them underwriters for purposes of the section 2(3) exception. And it creates some new problems as well.

2. B Reorganizations

In a direct exchange between the acquiring corporation and the acquired corporation's shareholders, but for the use of the section 2(3) exception, the status of such a shareholder vis-à-vis the acquired corporation is unimportant in determining whether he is an underwriter. To be an underwriter in a B reorganization, a recipient of securities must either become an affiliate of the acquiring corporation or qualify under section 2(11). Therefore, the use of the section 2(3) exception in a B reorganization subjects acquired-corporation affiliates to the disabilities attending underwriter status, while absent the use of the exception they would not be underwriters and would not be subject to those disabilities. Here, then, is the greatest anomaly created by the SEC's approach to the problem of negotiation gunjumping. It is clear that a better solution to this problem is needed.

IV. SUMMARY AND PROPOSALS

Negotiations must precede corporate reorganizations. If they take place prior to registration of the securities that will be distributed in the reorganization, they are likely to violate section 5(c) of the Securities Act as involving "attempts to dispose" of acquiring-corporation securities without registration. Excepting the negotiations as offers under section 2(3) by terming the target corporation

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affiliate negotiators "underwriters" is an imperfect solution to this dilemma. Further, acquired-corporation affiliates need the protection of section 5. An approach is needed that will reconcile the need for buyer protection with the necessity for prereorganization negotiations.

The basic problem lies in the effects of underwriter status. Underwriters are subject to resale restrictions and potential section 11 liability, and, in addition they cannot enjoy the protection the securities acts give purchasers generally. It is highly questionable whether imposing these disabilities upon acquired-corporation affiliates through rule 145(c) or through the section 2(3) exception can be justified solely because of affiliate status with the acquired corporation.

What is needed is an administrative policy or, preferably, a rule exempting prereorganization negotiations and agreements from the definition of "offer to sell" and "offer to buy" in section 5(c) without deeming acquired-corporation affiliates underwriters. Similarly, rule 145(c) should be altered to take the emphasis off an individual's status within the acquired corporation.\(^{185}\)

Excluding apparent attempts to dispose from the definition of "offer" is not unprecedented. The SEC has done so in several instances, two of which have already been noted. The first involves the need to give "some adequate form of notice" of the fairness hearing to all persons to whom securities will be issued pursuant to section 3(a)(10) as a prerequisite to obtaining the exemption.\(^{186}\) The second is inquiry by an issuer to verify its reasonable grounds to believe that prospective private placees satisfy the requirements of proposed rule 146(d).\(^{187}\) A third example is the submission for shareholder approval of a proposal to create new securities or to offer authorized but unissued securities in a recapitalization. The solicitation of approval, even where the securities involved are ultimately going to be offered to the same shareholders, has been permitted prior to the filing of a registration statement.\(^{188}\)

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\(^{185}\) Note, supra note 152, at 957-61. At a minimum, rule 145(c) should be rephrased so that the branch of section 2(11) consisting of the phrase "purchase from with a view to distribution" would be part of the rule's definition and bring about uniformity in treatment of negotiations for A, B, and C reorganizations.

\(^{186}\) See note 45 supra and accompanying text.

\(^{187}\) See note 70 supra and accompanying text.

\(^{188}\) 1 Loss 542-43. The rule here proposed would allow the section 2(11) definition of underwriter to be applied without strain. Underwriter status would no longer be grafted onto acquired-corporation affiliates (1) who receive and resell small amounts of acquiring-corporation securities but do not resell their securities or any other securi-
The proposed approach to the problem of negotiation gunjumping would solve the problems inherent in the present SEC approach. It would eliminate the present uncertainty in identifying which acquired-corporation negotiators qualify as underwriters. It would also resolve the present conflict between the acquiring corporation's desire that the negotiations not be subject to section 5 with the goal of acquired-corporation negotiators to negotiate without the burdens of underwriter status. Moreover, acquired-corporation affiliates would not be underwriters by reason of their affiliate status alone. And since the exception to the definition of "offer" would only be for purposes of section 5(c), there still would be a section 2(3) "offer" and "sale" upon which acquired-corporation affiliates could base actions under the various antifraud provisions of the securities acts.

Since the proposed rule would allow offers to be made during the negotiations without the usual protective disclosure, it should limit the number of persons who can represent the acquired corporation at the negotiations. Affiliate status with the acquired corporation could be required of all negotiators. Since being an affiliate of the acquired corporation would not incur underwriter status, the use of an affiliate test would not be as objectionable under the proposed rule as it is under the current practice.¹⁸⁹

Finally, the rule should provide for some form of required disclosure by the acquiring corporation. Since section 5(c) will be circumvented, some other means should be devised to give "offerees" in the negotiations the information they need. Perhaps the solution is to require an abbreviated filing with the SEC prior to beginning the negotiations, which could be given to the acquired-corporation negotiators.¹⁹⁰

In summary, the problems caused by using the section 2(3) exception to permit prereorganization negotiations can be solved by creating by rule a new exception to section 5(c) which will permit ties for the issuer, and (2) who receive large amounts of such securities with no intention to resell and who do not sell other securities for the issuer.

¹⁸⁹ To obviate problems in identifying affiliates of the acquired corporation, see notes 108-19 supra and accompanying text, the rule could permit the acquiring corporation to negotiate with those persons in the acquired corporation with whom it has reason to believe it must negotiate in order to properly finalize the terms of the reorganization.

¹⁹⁰ The filing could be similar to that required under rule 146. See notes 99-104 supra and accompanying text. For example, unaudited financial statements might be allowed. If the acquiring corporation is a reporting company, the use of its latest reports should suffice.
those negotiations. Such a rule would protect the acquiring corporation from the threat of gunjumping and at the same time ensure that acquired-corporation negotiators receive the information they need. It would not render persons underwriters solely on the basis of their positions within the acquired corporation, but would allow the section 2(11) definition of “underwriter” to operate in a normal fashion.

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