STATE REGULATION OF SECURITIES ISSUED IN CORPORATE REORGANIZATIONS: A CLOUD IN THE BLUE SKY

In spite of the comprehensive investor protection goals of state securities laws, securities issued in the course of corporate reorganizations are either exempted or excluded from registration requirements in most states. The author analyzes the absence of blue sky law coverage in this area in the light of the traditional rationales offered to justify the exemptions or exclusions, the federal approach to the problem as expressed in SEC rule 145, and the alternatives adopted or proposed in several selected states. The author concludes that reorganization-issued securities must be subjected to registration and critical review by state blue sky administrators in order to assure an adequate level of investor protection.

I. INTRODUCTION

The issuance of securities in corporate reorganizations presents much the same need for investor protection as do distributions of securities for cash. Nevertheless, most state securities acts exempt from their registration provisions, or exclude from all their provisions, securities issued in statutory mergers and consolidations and in exchanges of substantially all the assets of one corporation for the securities of another.1 The Securities and Exchange Commission (SEC) has taken the position, through the promulgation of rule 145,2 that these reorganization-issued securities are subject to the registration requirements of the Securities Act of 1933 (Securities Act).3 This change in the federal law should prompt a reassessment of the blue sky positions on securities issued in corporate reorganizations.

Blue sky regulation of securities issued in corporate reorganiza-

1. The language of many blue sky laws, including those patterned after the Uniform Securities Act (USA), may embrace other forms of reorganization (most notably reclassifications), but it has been in the merger, consolidation, and sale of assets contexts that the use of reorganization machinery in the distribution of securities has raised concerns about investor protection.
tions seems to have gone largely unnoticed. In comparison, federal regulation of securities issued in statutory mergers and consolidations, exchanges of assets, and other corporate reorganizations has had what has been described as a "protean" history. First, the SEC adopted a "no-sale" theory—that the exchange of securities in certain corporate reorganizations was not a "sale" and therefore not covered by the federal securities laws. Over the course of almost four decades, the scope of this policy was narrowed by administrative and judicial decisions. Finally, it was reversed by the adoption of rule 145, which requires compliance with the disclosure provisions of the Securities Act. Throughout the 40-year history of the no-sale policy, SEC and judicial treatment of securities issued in corporate reorganizations was closely followed. Numerous SEC re-


leases and rulings, a significant amount of case law, and a flood of largely critical literature in the law journals kept the legal profession constantly aware of the problems and changes in federal regulation of these securities.

Throughout this period, blue sky treatment of reorganizations was often ignored by the literature\(^7\) and by practitioners.\(^8\) In the light of new rule 145, current blue sky treatment of securities issued in these corporate reorganizations should come into question. The central issue will be whether or not these securities should be required to meet the registration provisions of state securities acts and, if so, how should this registration be given effect? While both federal and state securities acts have investor protection as their basic goals, they generally take different, complementary approaches. The federal securities acts focus on giving the investor full, structured disclosure of pertinent information about the issuer, while the blue sky laws typically afford a critical administrative review of the quality of the security before sale is permitted in the jurisdiction.\(^9\) Together, the federal securities acts and blue sky laws can provide a fairly comprehensive scheme of investor protection. Given this in-

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8. Several years ago, one commentator suggested why this may be the case:

That this situation should have existed is attributable to several factors: (1) few practitioners recognize that the blue-sky laws apply to offerings to a very few persons, and yet frequently it is the small or closely held corporation which is involved in these corporate events; (2) few practitioners are willing to concede that the blue-sky laws have general application to these corporate events; (3) those practitioners who understand that the blue-sky laws apply to these corporate events have been lulled into non-compliance with the state statutes either because they hope that the “no-sale theory” will afford some protection at the state level or because they believe that the administrators are happy to ignore this non-compliance; and (4) most administrators, having insufficient time or resources to fully enforce their statutes, are happy to ignore this non-compliance—non-compliance which they do not believe in most instances to be detrimental to the investing public.

Cowett, supra note 7, at 427. At the time this observation was made, fewer states formally exempted or excluded mergers and consolidations from the registration requirements than do now. See notes 86-87 infra and accompanying text. See also L. LOSS & E. COWETT, BLUE SKY LAW 45-46 (1958) [hereinafter cited as LOSS & COWETT].

9. See notes 77-85 and accompanying text. Nonetheless, the blue sky administrator may become interested in disclosure as well, often as part of the “fairness” determination made by the agency. See note 143 infra. See also USA § 304(d).
terplay between federal and blue sky activity, the system of investor protection in the reorganization context will not be complete until a complementary plan of state regulation is developed to fill the current void in blue sky law regulation.

This Note examines the rationales behind the traditional treatment of reorganization securities, the historical development of the current SEC position, and the blue sky law treatment of securities issued in corporate reorganizations. It concludes with a call for changes in the current blue sky treatment of reorganization securities.

II. SECURITIES ISSUED IN MERGERS AND CONSOLIDATIONS: WHY REGULATE AT ALL?

Several rationales have been proffered for excepting securities issued through reorganizations from the treatment usually afforded securities issues. By bringing reorganization-issued securities under the aegis of the federal Securities Act through rule 145, the SEC has implicitly rejected those rationales. Nevertheless they retain the imprimatur of the states and accordingly warrant an examination in this Note.

A. The “No Volition” Rationale

The most common argument is that in most reorganizations there is no offer or sale of securities because the shareholders receiving securities in a reorganization do not give value. The crux of the argument is that the value element of an offer or a sale must be voluntarily-surrendered consideration, and, in a reorganization approved only when a majority or two-thirds of the shareholders so agree, individuals do not surrender value voluntarily in the transaction. It is argued that a statutory merger or consolidation is essentially a corporate act which binds the shareholder and transfers his securities by operation of law.

The absence of value provides two reasons for withholding the protective provisions of the Securities Act. First, the definition of sale is not met, so the statute on its face does not apply. Second,

10. The Securities Act defines “sale” as including “every contract of sale or disposition of a security or interest in a security, for value.” The Act's definition of “offer” also has a “value” element. Securities Act § 2(3), 15 U.S.C. § 77b(3) (1970). Similar definitions are found in the blue sky laws. See, e.g., USA § 401(j)(1), (2).
11. See note 31 infra.
12. Id.
securities regulation policy is inapplicable to a nonvolitional receipt of securities: registration of securities is intended to help the investor select securities that are best for him by ensuring that the investor is fully informed or by prohibiting the sale of undesirable securities.\textsuperscript{13} This rationale has been widely criticized.\textsuperscript{14} It has been suggested that it "overlooks the substance of [the] transaction and ignores the fundamental nature of the relationship between the stockholders and the corporation and between stockholders."\textsuperscript{15} In order to vote, each shareholder must in fact decide whether or not the proposed plan of reorganization will serve his best interests. Further, after the vote he may choose to exercise his dissenter's appraisal rights, if available to him under state law.\textsuperscript{16} The dissenter's right gives him a true choice—to retain his securities and participate in the subsequent exchange or to accept an alternative cash payment. This choice would be facilitated by the same disclosure of information that securities regulation would require for an issuance of securities for cash.\textsuperscript{17} Moreover, there is at least some collective volition in the vote on a plan of reorganization. The shareholders must band together for majority approval. While no one shareholder can make the reorganization decision, the collective volition of the majority should be sufficient to find a sale.\textsuperscript{18}

B. The "Shareholder Knowledge and Approval" Rationale

A second rationale for exempting or excluding securities issued in statutory mergers or consolidations is that the shareholder is in a position to evaluate the transaction without securities law protection. It is argued that shareholders as a group are close enough to the operation of the business to know, or to have access to, the information needed to make an intelligent investor choice without federal or state securities act protection. Alternatively, the dependency of the directors on the shareholders for retaining their directorships is seen as providing the shareholders an indirect influence over the plan of reorganization, since typically the directors are authorized to form-

\textsuperscript{13} The federal and state approaches to securities regulation are discussed at notes 76-85 infra.
\textsuperscript{14} See note 6 supra.
\textsuperscript{15} SEC Staff Report cited in Cohen, supra note 6, at 173.
\textsuperscript{16} See, e.g., ABA-ALI Model Bus. Corp. Act §§ 80, 81 (1969) [hereinafter cited as MBCA].
\textsuperscript{17} See SEC Securities Act Release No. 5316 (Oct. 6, 1972).
\textsuperscript{18} Id.
ulate such plans. This situation affords shareholders an added measure of self-protection, which lessens the need for governmental protection.

This rationale, however, ignores the realities of the reorganization transaction. Most shareholders in any but a very closely held corporation will not be privy to all the information necessary to form an intelligent evaluation of the reorganization plan. Furthermore, only the holder of a large percentage of the stock will have the leverage to force disclosure of that information by the corporations or other principals involved in the reorganization. Moreover, the leverage of the shareholders may be no substitute for the structured, itemized disclosure requirements of the securities laws; the shareholders may not be sophisticated enough to know what information to seek or to discern corporation bias in the manner of its presentation.

The notion that shareholder election of the board of directors and, indirectly, of management will protect the interests of the shareholders is likewise unrealistic. Aside from the general problem of management control of the proxy machinery and the tendency of shareholders to give perfunctory approval to management recommendations, more particular concerns may be present in the reorganization situation. Often management and shareholders will have totally different objectives in a proposed reorganization. For example, management may be swayed by the offer of long-term employment contracts, consulting fees, or stock options, to the neglect of the best interests of the shareholders, despite the fiduciary obligations of management.

C. The "Mere Change in the Form of Investment" Rationale

The third rationale for not demanding registration of securities issued in reorganizations is that the exchange of securities involves little more than a change in the form of the shareholders' investment.

19. Even where the shareholder has an investment representative handling his interests, there may be substantial difficulties. See Schneider & Manko, supra note 5, at 993.


The implicit assumption of this rationale is that cash sales of securities should be the primary concern of the securities laws. As seen from a broad economic perspective, the securities laws appear to be designed to help bring about a proper allocation of new economic resources through informed investor choice. In reorganizations, where investments have already been made but are being reshuffled among investors, no new economic resources are being allocated, so the need for regulation is less pressing.22

The argument that a mere change in the form of an investment does not warrant protective regulation errs in focusing solely upon the allocation-of-new-resources rationale for securities regulation, for it ignores the need to help the individual investor select the securities that are best for him. In a statutory merger or consolidation, the security holder is surrendering rights in one enterprise for new rights in a different enterprise. The assets underlying his investment may change considerably, so that the character of his new investment will differ from that of the old. The nature of his interest in the surviving or constituent corporation may also be quite different; a controlling shareholder in the acquired corporation may become a noncontrolling shareholder in the acquiring corporation.23 Furthermore, where a widely-held, publicly-traded corporation acquires a closely-held corporation, the shareholder of the acquired corpora-

22. See, e.g., a 1938 SEC report to Congress, which stated that the provisions of the Securities Act:

... were designed primarily to establish standards of disclosure in new financing and its mechanics were specifically adapted to that end. The registration and prospectus provisions of the act are not applicable to such specialized reorganization situations as those presented where stockholders' proxies or assents are solicited in approval of the typical merger, consolidation, or sale of assets.


The rationale also looks for further support to the income tax laws that give non-recognition treatment where shareholders exchange securities in certain reorganizations. See, e.g., INT. REV. CODE OF 1954, §§ 354, 361, 368(a) (1)(A). But the policies underlying the tax treatment of reorganizations are quite different from those behind the securities acts and therefore do not afford much support for the "mere change in form" rationale. For example, the exchange of securities through a tender offer may qualify for nonrecognition under the tax laws (INT. REV. CODE OF 1954, §§ 354, 361, 368(a)(1)(B)), while such exchanges are usually subject to the disclosure provisions of the Securities Act, even though the SEC excluded other reorganization issues of securities from the Act. Cf. 19 CASE W. RES. L. REV. 1148 (1968).

23. The underwriter status of shareholders under the Securities Act is discussed at note 73 infra.
tion receives a much more liquid asset than he had before and one subject to the fluctuations of the trading markets. Likewise, statutory protection is needed where the shareholder takes securities in a closely-held surviving corporation. Again, the character of his investment in the surviving corporation may be transformed. Moreover, information about his new investment may be less available in the closely-held survivor than in the publicly-traded survivor, since the marketplace tends to generate information about securities with which it deals. In either case, any change in management will also be of great import to the investor. In sum, the exchanges involved in these reorganizations must be characterized for purposes of the securities laws as more than mere changes in the forms of the shareholders’ investments. The argument that an allocation of new economic resources is of substantially more concern than a reallocation of already invested resources is suspect. Reorganizations do, in fact, involve important reallocations of financial resources. The decision whether to reallocate at all, and to what end, should be made with full information and with the same administrative review accorded other distributions.

D. The “Existing Law is Sufficient” Rationale

A final rationale is that securities issued in mergers, consolidations, and exchanges of securities for corporate assets can be exempted or excluded from provisions of the blue sky laws because a large, separate body of federal and state statutory and judicial authority is available to assure reorganization fairness and protect the investor.\(^24\) In addition, it is argued that any further regulation would improperly intrude on this existing body of law.

The inadequacies of this rationale are discussed later in this Note.\(^25\) Briefly, it ignores the basic blue sky law approach to investor protection, which is to assure both the full disclosure to the agency of facts surrounding the issuance and the quality of the security before it is offered to the public.\(^26\) Further, the means of ensuring fairness outside the registration and antifraud provisions of the securities laws sometimes pose greater hurdles to plaintiffs than remedies under the securities acts.\(^27\)

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24. See Draftsmen’s Commentary to USA § 401(j), in Loss & Cowett 347.
25. See text accompanying notes 93-113 infra.
26. See text accompanying notes 76-85 infra.
27. See notes 113-15 infra and accompanying text.
In summary, the four rationales in support of exclusion or exemption of reorganization-issued securities fail to afford investors in this context the protection that they would receive if they purchased new securities for cash, even though the need for protection is similar. This is not to suggest that all reorganizations present these same concerns. For example, mergers that merely change the domicile of a corporation, reorganizations undertaken only to effect a technical restructuring of the corporation, and certain “upside down” mergers may not require investor protection because the nature and character of the shareholders’ interests in the underlying investment do not change in these situations.28

28. (a) Change of Domicile: Rule 145 recognizes that Securities Act disclosure is not needed in this situation by specifically exempting mergers or consolidations “where the sole purpose of the transaction is to change an issuer’s domicile.” 17 C.F.R. § 230.145(a)(2) (1972). See generally Schneider & Manko, supra note 5, at 813-14. Some blue sky administrators have taken a similar position. See, e.g., Ohio Securities Bull., Sept. 1973, at 4. Problems may exist where a change in domicile results in a move from a state whose corporation statute allows, for example, preemptive rights, director indemnification, or cumulative voting to a state which does not have such provisions in its corporation statute. See Heyman, supra note 5, at 795-97.

(b) Technical Restructuring: See, e.g., In re Penn Central Securities Litigation, 347 F. Supp. 1327 (E.D. Pa. 1972), modified, 357 F. Supp. 869 (E.D. Pa. 1973) (no “sale” for purposes of various provisions of the federal securities laws). The internal reorganization of a corporation into a parent holding company with subsidiaries may also involve only a technical restructuring of the business with no change in the underlying assets or rights of investors.

(c) “Upside Down” Merger: Where a large corporation is acquired by a small corporation, the securities of the acquiring corporation taken by the shareholders of the acquired corporation do not represent a substantial change in the underlying assets for the shareholders of the acquired corporation. The shareholders of the acquired company are invested in essentially the same assets as they were before the merger. However, the shareholders of the acquiring corporation will have a substantially new investment after the reorganization. These investors deserve the protection of the Securities Act. Neither old rule 133 nor new rule 145 drew such distinctions in the scope of their coverage. See notes 31-73 infra and accompanying text. Similar considerations are present in the sale-of-assets situation, where a large corporation sells all or substantially all of its assets to a small corporation in exchange for securities of the small corporation, which are in turn distributed to the shareholders of the large corporation. The assets underlying the investment of the selling corporation’s shareholders do not change significantly, while the investment of the purchasing company’s shareholders does change. Yet the shareholders of the purchasing company are often denied a vote on this transaction under state corporation law; typically, a vote is allowed only for the sale of all or substantially all corporate assets. See, e.g., MBCA § 79. Some judicial authority would recast the transaction to make available a shareholder vote and/or dissenter’s appraisal rights in this situation. The transaction is deemed to be a de facto merger. See Rath v. Rath Packing Co., 257 Iowa 1277, 136 N.W.2d
III. THE FEDERAL BACKGROUND TO BLUE SKY REGULATION OF SECURITIES ISSUED IN CORPORATE REORGANIZATIONS

Soon after its creation in 1934, the SEC decided that certain corporate reorganizations were outside the scope of regulation under the Securities Act of 1933. By administrative interpretation the SEC stated that reorganizations carried out after majority approval by the shareholders were “no-sale” exchanges. The no-sale rationale was that shareholders received securities issued in these shareholder-vote reorganizations without exercising individual volition and hence did not give the “value” requisite to a “sale” as defined by the Securities Act. The SEC maintained that there was no individual volition in these transactions because they were corporate

29. For more exhaustive treatments of the history and development of SEC regulation of mergers and consolidations, focusing on rule 133 and the “no-sale” theory, see notes 3 and 6 supra.

30. Section 2(3) of the Securities Act states that:

[the term “sale” or “sell” shall include every contract of sale or disposition of a security or interest in a security, for value. The term “offer to sell”, “offer for sale”, or “offer” shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.


The SEC “no-sale” approach to statutory mergers, consolidations and certain other corporate transactions was initially stated by the SEC in a note to rule 5 of the instructions for the use of SEC Form E-1, a registration form once used in business reorganizations. SEC Securities Act Release No. 493 (C) (Sept. 20, 1935). This statement of the no-sale rule was rescinded in 1947. SEC Securities Act Release No. 3211 (April 14, 1947). Nonetheless, the SEC continued to follow the rule in practice, and in 1951 that practice was codified in rule 133. SEC Securities Act Release No. 3420 (Aug. 2, 1951). Then, in 1959, after the rescission of the rule had been proposed and debated, rule 133 was amended to eliminate its application to specified secondary distributions following reorganizations. SEC Securities Act Release No. 4115 (July 16, 1959). The amended rule 133 remained operative until January 1, 1973, when it was replaced by rule 145. SEC Securities Act Release No. 5316 (Oct. 6, 1972).
acts which bound the shareholders (except for dissenters' rights under state law). 31

This administrative interpretation conflicted with two explicit exemptions in the Securities Act. Section 3(a)(9) exempts securities issued in recapitalizations where no commissions are paid to solicit the exchange; 32 the no-sale theory allowed such exchanges without registration regardless of commissions. Similarly, the section 3(a)(10) exemption for exchanges of securities for securities pursuant to a hearing on fairness by a governmental agency or court 33 was undermined by the no-sale rule, which gave the same

31. See text accompanying notes 10-13 supra. The underlying rationale of the no-sale rule was probably articulated most clearly in an amicus curiae brief filed by the SEC in National Supply Co. v. Leland Stanford Jr. University, 134 F.2d 689 (9th Cir.), cert. denied, 320 U.S. 773 (1943). The brief, quoted in Throop, In Defense of Rule 133—A Case for Administrative Self-Restraint, supra note 6, at 394, stated:

In . . . consolidations and mergers the alteration of the stockholder's security occurs not because he consents to an exchange, but because the corporation by authorized corporate action converts his security from one form to another. . . . [T]here is no sale where (1) the vote of the stockholders is effective (subject to directors' action and other statutory requirements) as corporate action and (2) this action binds all stockholders, assenters, dissenters, and non-voters alike (subject only to appraisal rights of dissenters). . . . [I]n such cases a proposed corporate act is submitted to stockholders to be accepted or rejected by them as a class, in their capacity as members of the corporate body. Even though the stockholder may participate in the vote which results in changing his rights as a stockholder, his action in so doing is the action of a member of the corporation exercising his franchise, rather than the action of a security-holder choosing to accept an offer of exchange made to him as an individual; and obversely, the solicitation of his vote is nothing more than a request for the exercise of his franchise as a member of the corporation, not an offer of exchange or sale of new securities to him as an individual. He is functioning precisely as he would be if he were voting on a charter amendment which would, for example, change the corporate purposes. The fact that his rights will be changed if the consolidation or merger is effected is a mere incident of the corporate action in which he is participating.

The SEC also early adopted the rationales focusing on the form of the investment and shareholder approval. See note 22 supra. See also Cohen, supra note 6, at 173-75; Friedman, The Concepts of Purchase and Sale Under the Federal Securities Laws, 14 N.Y.L.F. 608, 608-10 (1968); Lacour, supra note 6, at 366. See generally 1 Loss 512-16, 518-24.

32. Section 3(a)(9) of the Securities Act exempts "[a]ny security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." 15 U.S.C. § 77c(a)(9) (1970).

33. Section 3(a)(10) exempts

[a]ny 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
exemption without a hearing. \textsuperscript{34} It also ran counter to a comment in the House Report to the effect that reorganizations without judicial supervision were not exempted by section 3(a)(10) or elsewhere in the Act because they possessed "all the dangers implicit in the issuance of new securities." \textsuperscript{35}

Almost from the outset the SEC limited the scope of the no-sale theory. \textsuperscript{36} It denied use of the exclusion where a unanimous vote of security holders was required to approve the plan of reorganization. \textsuperscript{37} It also denied the exclusion where the security holders were offered a choice of securities in the proposed exchange. \textsuperscript{38} In each

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.


35. This comment was made in a discussion of the exemption afforded securities issued in reorganizations approved by a court or administrative agency (Securities Act § 3(a)(10)). H.R. Rep. No. 85, 73d Cong., 1st Sess. 16 (1933). Professor Loss's response was classic understatement: "If this [legislative history] does not say in so many words that mergers and the like effectuated by 'corporate' rather than 'individual' action are covered by the statute unless specifically exempted, it does seem to squint pretty hard in that direction." 1 Loss 519.

36. Early concern focused on the abuse and potential abuse under the "no-sale" theory. The limitations imposed upon the application of the no-sale theory may have been prompted by the large number of unregistered issues which it fostered. Professor Loss has noted that the no-sale theory permitted the offering of billions of unregistered securities. 1 Loss 522, citing three proposed amendments in Hearing on a Comparative Print Showing Proposed Changes in the Securities Act of 1933 & The Securities Exchange Act of 1934 and H.R. 4344, H.R. 5065, & H.R. 5832, Bills Related to Proposed Amendments to the Securities Act of 1933 & to the Securities Exchange Act of 1934 Before the House Comm. on Interstate & Foreign Commerce, 77th Cong., 1st Sess., pts. 1-6, at 895 (1941). More recently, another commentator noted that acquisitions rival conventional offerings as a means of issuing stock. Schneider, supra note 6, at 1340.

37. See 1 Loss 522; Note, The SEC's No-Sale Rule and Exchanges of Securities Pursuant to Voluntary Reorganization, supra note 6, at 1239-40.

38. Id.
case the SEC reasoned that individual participation was dependent on the shareholder's own choice, not corporate action, so that the "voluntariness" needed for a sale under the Securities Act was present. For the same reason, the rule did not apply to tender offers, in which the acquiring corporation made the exchange offer directly to each individual shareholder of the target corporation.\footnote{39} Finally, the SEC curbed the no-sale theory by allowing it to exempt securities transactions only from registration, not from the antifraud civil liability provisions of the federal securities laws.\footnote{40} When the policy was adopted as rule 133,\footnote{41} it was restricted to the section 5 registration requirement of the Securities Act.

Finally, two judicial decisions denied the no-sale exclusion for secondary distributions and for securities issued in a reorganization the purpose of which was to further disperse securities to the public. In \textit{SEC v. Micro-Moisture Controls, Inc.},\footnote{42} the SEC sought an injunction against a secondary distribution of unregistered securities following a sale of substantially all the assets of Converters Acceptance Corporation for the common stock of Micro-Moisture. Twenty-six of the 31 shareholders of Converters received the bulk of this issue of 2 million shares in a liquidating dividend and then combined to give to another group powers of attorney to sell the unregistered stock to brokers and dealers. This group plus other defendants were in actual control of Micro-Moisture. The defendants argued that rule 133 exempted the securities from registration for the secondary

\footnote{39. No shareholder vote occurs in the tender offer reorganization; therefore the traditional basis for invoking the no-sale rationale is missing. See generally \textit{Wheat Report} 251-52. The \textit{Wheat Report} found such distinctions, which turn on the method of business combination used, untenable and suggested alternative procedures to rule 133. \textit{Wheat Report} 253, 267-96. See notes 60-64 \textit{infra} and accompanying text.}

\footnote{40. In \textit{National Supply Co. v. Leland Stanford Jr. University}, 134 F.2d 689 (9th Cir.), \textit{cert. denied}, 320 U.S. 773 (1943), the SEC amicus curiae briefs drew a distinction between the broad possible scope of the no-sale theory and a more limited no-sale rule. Under the no-sale theory, the reorganization is deemed not to involve a "sale" within the Securities Act definition of that term, so neither the registration nor the general antifraud provisions, which are activated by a sale, can apply. The no-sale rule, on the other hand, excepted reorganizations with majority shareholder approval from only the registration provisions of section 5. This distinction may have gone unnoticed by the \textit{Leland Stanford} court. See Cohen, \textit{supra} note 6, at 164-68.}


distribution. Rejecting that defense, the court held rule 133 did not apply. It added that rule 133 was inapplicable to the whole transaction, since the shareholders of the acquired corporation were in control of the acquiring corporation and the reorganization was merely a step in a scheme to sell the stock to the public.\(^43\) In *Great Sweet Grass Oils, Ltd.*\(^44\) and *Kroy Oils, Ltd.*,\(^46\) two related delisting proceedings, the SEC likewise rejected rule 133 as a defense to sales of unregistered securities following a reorganization. There Great Sweet Grass and Kroy, a firm controlled by Great Sweet Grass through interlocking directors and a management contract, entered into a succession of corporate reorganizations and subsequently sold to the public millions of dollars worth of securities, unsupported by adequate corporate assets.\(^46\) The SEC found that the defendants had prearranged a substantial distribution of securities through the shareholders to the public. Under the circumstances, it reasoned, the shareholders were underwriters, selling for an issuer in connection with a public distribution of the securities.\(^47\) It stated that "where the persons negotiating an exchange, merger, or similar transaction have sufficient control of the voting stock to make a vote of stockholders a mere formality, rule 133 does not apply. In such case the transaction is not corporate action in a real sense, but rather is action reflecting the consent of the persons in control, and consequently results in a sale as to them."\(^48\) Accordingly, not even the first exchange of assets for stock was excluded from the definition of sale and free of the registration requirement.\(^49\)

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43. 148 F. Supp. at 562; SEC v. Culpepper, 270 F.2d at 248.
44. 37 S.E.C. 683 (1957), aff'd per curiam sub nom. Great Sweet Grass Oils, Ltd. v. SEC, 256 F.2d 893 (D.C. Cir. 1958).
47. Section 2(11) of the Securities Act defines "underwriter" as "any 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. . . ." 15 U.S.C. § 77(b)(11) (1970).
48. 37 S.E.C. at 691.
49. These three decisions and the problems they created have been the source of a great deal of commentary. See, e.g., 1 Loss 529-34; WHEAT REPORT 262-72; Orrick, Registration Problems Under the Federal Securities Act—Resales Following Rule 133 and Exchange Transactions, supra note 6, at 3-15; Purcell, supra note 6, at 261-69; Schneider, supra note 6, at 1324-27; Schneider & Kani, supra note 6, at 1625-33; Sommer, Mergers, Consolidations, Sales of Assets—Rule 133, supra note 6, at 23-24.
In 1959 rule 133 was amended to guard against public distributions under the guise of reorganizations by deeming certain shareholder-recipients of securities to be underwriters. First, paragraph (b) provided that parties who, pursuant to an agreement, purchased the issuer's securities from the constituent corporation's shareholders or offered or sold securities for them with a view toward distribution would be considered to be statutory underwriters. This change addressed the situation in *Great Sweet Grass* and would have made the selling group in that case section 2(11) underwriters. Second, paragraph (c) termed any affiliate of a constituent corporation who received the securities of an issuer with a view toward distribution to be an underwriter. These persons would not be considered underwriters, however, if they merely sold limited quantities of securities in brokers' transactions. Thus, the amendments attempted to protect the public from distributions of unregistered securities. It did so only partially, however, for security holders of a large number of securities who were not affiliates of a constituent corporation could resell them without registration, provided the resale was not pursuant to an arrangement for a distribution. Furthermore, this approach was often inequitable in that affiliates of acquired corporations were deemed underwriters even though after the reorganization they might not be affiliates of the issuer and hence could not exact registration from the issuer.

Amended rule 133 did not solve the general shortcomings of the no-sale theory. The limited exemptions afforded by sections 3(a)(9) and 3(a)(10) of the Securities Act were still undermined by the provisions of rule 133. Uncertainty as to the coverage of rule 133 continued in the case of closely-held corporations, because share-
holders were uncertain who would be deemed a "controlling person," and thus an underwriter, subject to restrictions on the resale of securities received in the reorganization.\textsuperscript{56} Applicability of the "negotiated transaction" doctrine of the SEC to reorganizations of closely-held companies was not predictable, because no clear SEC guidelines on the limits of this exception to rule 133 were developed.\textsuperscript{57} There also continued to be what have been described as "disclosure gaps"\textsuperscript{58} in instances where the target corporation was publicly held but not registered under section 12 of the Exchange Act.\textsuperscript{59} Shareholders in companies required to register under section 12 of the Exchange Act received proxy or information statements pursuant to the proxy rules and thus had current, reasonably complete information available to them, while companies not required to register under the Exchange Act were required by the general corporation statutes of many states only to send notice of the shareholder meeting. In addition, exemption from registration under rule 133 continued to turn on the form of reorganization selected by the parties involved.\textsuperscript{60} A statutory merger or consolidation or an exchange of assets for stock could be exempted from registration by rule 133, whereas a voluntary exchange of stock for stock (i.e., an acquisition by tender offer) was said to be a "sale" requiring registration. The form of reorganization chosen could also result in inconsistencies with respect to who was treated as an underwriter for resales following the reorganizations. In the tender-offer situation, the "non-controlling shareholders of the acquiring corporation who, before the acquisition, were in control of the acquired corporation, are generally deemed not to be underwriters and are therefore free to resell their new securities when they wish to do so without registration."\textsuperscript{61} But in a merger, consolidation, or sale of assets where the shareholders voted on the plan of reorganization, a controlling person of the acquired corporation who did not control the acquiring

\textsuperscript{56} Wheat Report 262-66; Schneider & Kant, supra note 6, at 1625-28; Sommer, \textit{Who's "In Control"?—SEC, supra note 6.}

\textsuperscript{57} Schneider & Kant, supra note 6, at 1628-29.

\textsuperscript{58} Wheat Report 267-72.


\textsuperscript{60} See note 39 supra and accompanying text.

\textsuperscript{61} Wheat Report 270-71. In fact, control persons of the acquired corporation may have been deemed underwriters, at least for a period of time, under the "selling for" language of section 2(11) of the Securities Act. \textit{See} 4 Loss 2562 (Supp. 1969); Note, \textit{Prereorganization Negotiations and Securities Act Section 5(c): A Proposed Solution to the Gunjumping Problem, 24 Case W. Res. L. Rev. 731, 751-55 (1973).}
corporation could become an underwriter by virtue of rule 133(c). Though a mere non-controlling shareholder of the issuer, he could be exposed, upon resale of his securities, to liability for fraud and for violations of the full disclosure requirements of the Securities Act, despite an inability to avert those violations. Problems under rule 133 necessitated a change in SEC policy on business reorganizations. A study of SEC disclosure policies released in 1969 focused attention on such a need and suggested several possible solutions to problems presented by the no-sale rule. The result, after some years of further study, comment, and debate, was the rescission of rule 133 and the adoption of rule 145 and related provisions.

Rule 145 effects a complete reversal of rule 133. Reclassifications of securities, statutory mergers, and consolidations, and the exchange of assets for securities, all pursuant to a plan of reorganization voted on or consented to by the shareholders who will receive the securities in the exchange, are now considered sales of securities. Therefore, these securities must be registered under the 

62. Id.
64. Id. at 273-76.
66. 17 C.F.R. § 230.145(a) (1972) provides:

Transactions within this section: 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, so far as the security holders of a corporation or other person are concerned where pursuant to statutory provisions of the jurisdiction under which such corporation or other person is organized, or pursuant to provisions contained in its certificate of incorporation or similar controlling instruments, or otherwise, there is submitted for the vote or consent of such security holders a plan or agreement for—

(1) Reclassifications. A reclassification of securities of such corporation or other person, other than a stock split, reverse stock split, or change in par value, which involves the substitution of a security for another security; 

(2) Mergers or consolidations. A statutory merger or consolidation or similar plan of acquisition in which securities of such corporation or other person held by such security holders will become or be exchanged for securities of any other person, except where the sole purpose of the transaction is to change an issuer's domicile; or 

(3) Transfers of assets. A transfer of assets of such corporation or other person, to another person in consideration of the issuance of securities of such other person or any of its affiliates, if:

(i) Such plan or agreement provides for dissolution of the corporation or other person whose security holders are voting or consenting; or
In addition, rule 145(c) provides for registration in the case of secondary distributions following a reorganization by assigning underwriter status, more liberally than amended rule 133, to any party or affiliate of a party to a reorganization other than the issuer. A limited provision for the resale without registration un-

(ii) Such plan or agreement provides for a pro rata or similar distribution of such securities to the security holders voting or consenting; or

(iii) The board of directors or similar representatives of such corporation or other person, adopts resolutions relative to subdivision (i) or (ii) of this subparagraph within 1 year after the taking of such vote or consent; or

(iv) The transfer of assets is a part of a preexisting plan for distribution of such securities, notwithstanding subdivision (i), (ii), or (iii) of this subparagraph.

In the first draft of the American Law Institute’s Federal Securities Code project, the definitions of “sale” and “offer” specifically include the “issuance of a security pursuant to a merger, consolidation, recapitalization, or transfer of assets for securities.” ALI FED. SEC. CODE § 293(f)(3) (Tent. Draft No. 1, April 25, 1972). In the Introductory Memorandum to this draft, Professor Loss, Reporter for the Code, remarked:

The “no sale” theory—which enabled the Commission in its early days to construct an extrastatutory exemption from Securities Act registration by defining “sale” so as to exclude mergers and similar reorganizations effected by class votes, but which the Commission has been trying to narrow or get rid of for some years—will be gone at long last.

Loss, Reporter’s Introductory Memorandum to ALI FED. SEC. CODE at xxvi (Tent. Draft No. 1, April 25, 1972).

67. 17 C.F.R. § 230.145(c) (1972).

68. Rule 145(c) states:

Persons and parties deemed to be underwriters. For purposes of this section any party to any transaction specified in paragraph (a) of this section, 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. The term “party” as used in this paragraph (c) shall mean the corporations, business entities, or other persons, other than the issuer, whose assets or capital structure are affected by the transactions specified in paragraph (a) of this Section.

17 C.F.R. § 230.145(c) (1972).

Under rule 133(c), to be an underwriter the person transacting with the issuer had to purchase the securities with a view toward distribution, a requirement which is one of the statutory standards of the section 2(11) definition. 17 C.F.R. § 230.133(c) (1972). See notes 47-48 supra and accompanying text. Under rule 145(c), controlling persons of the acquired corporation are given underwriter status regardless of their investment intent or the size of their new interest in the acquiring corporation. 17 C.F.R. § 230.145(c) (1972). Resales by these underwriters are allowed under the limited provisions of paragraph (d). 17 C.F.R. § 230.145(d) (1972). See note 69 infra.
REORGANIZATION SECURITIES

The registration procedure for securities issued through rule 145 reorganizations is less burdensome than the disclosure required in nonreorganization issues. Essentially, the registrant must provide the information that either the proxy solicitation or the information statement provisions of section 14 of the Exchange Act require. The use of proxy information in the registration statement and prospectus is less burdensome than full registration under the Securities Act. Companies subject to the proxy rules will already have completed much of the groundwork. Companies not subject to the proxy rules will have to prepare a new document, but performance of this task is less burdensome than the disclosure required under sections 5, 6, and 7 of the Securities Act.

Since section 2(11) seems to require that an underwriter have a view toward distribution, section 145(c) of the rule may be outside the scope of SEC rule-making power.

69. 17 C.F.R. § 230.145(d) (1972). Rule 145(d) requires that these re-sales comply with paragraphs (c), (e), (f), and (g) of rule 144. In brief, sales of securities in quantities less than a limited percentage of the outstanding shares of the class of stock may be made through unsolicited broker's transactions, provided that adequate public information is extant. 17 C.F.R. § 230.144(c), (e), (f), (g) (1972). See SEC Securities Act Release No. 5306 (Sept. 26, 1972).

70. SEC Securities Act Release No. 5316 (Oct. 6, 1972) streamlined and simplified form S-14, which is used for registration of securities issued in transactions covered by rule 145. This form is divided into two parts. Part I, the prospectus-proxy statement, is the important public disclosure section of amended Form S-14. It calls for the information required under section 14(a) or section 14(c) of the Exchange Act, 15 U.S.C. §§ 78n(a), (c) (1970), regardless of whether or not the registrant is otherwise subject to those sections of the Exchange Act. The form of presentation of the information may also follow that of a proxy or information statement under section 14. Additional information must be included at the time of any resale by persons deemed to be underwriters under paragraph (c) of rule 145, so that disclosure before the secondary distribution is current and complete. Id. See Schneider & Manko, supra note 5, at 820-22; Note, Business Combinations and Registration Requirements: SEC Rule 145, supra note 5, at 946-48. The proxy rules relevant to registration under rule 145 have also been amended to comply with the rule's requirements. 17 C.F.R. §§ 240.14a-2(d), 240.14a-6, 240.15c-5 (1972). Part II of S-14, which is not part of the prospectus, must contain, inter alia, a statement of the interests in the corporation of any experts who prepared or certified material for the registration statement, disclosure of indemnification agreements for the protection of directors or officers, a list of exhibits filed with the registration statement, and an undertaking to file updating amendments as necessary (a provision critical to secondary distributions).


72. 15 U.S.C. §§ 77(c), (f), (g) (1970). See Schneider & Manko, supra note 5, at 820-22; Note, Business Combinations and Registration Require-
In sum, rule 145 secures a basic level of information disclosure to investors in certain corporate reorganizations where previously none was required. It affords an opportunity for an informed vote on the plan of reorganization and assures that any secondary offering to the public of securities previously distributed in the reorganization, made by rule 145(c) underwriters, will include a fairly complete and updated prospectus.73

IV. CURRENT BLUE SKY LAW TREATMENT OF SECURITIES ISSUED IN CORPORATE REORGANIZATIONS

Almost every blue sky law speaks directly to securities issued in mergers, consolidations, and sales of assets, usually by exempting them from the registration provisions or by excluding them from all the provisions of the state securities act.74 The blue sky transaction exemption resembles SEC practice under the no-sale rule.75 Moreover, the SEC's no-sale theory was expressly incorporated in the Uniform Securities Act,76 which was the model followed by states that adopted the definitional exclusion approach for these reorganization-issued securities. Now the SEC's adoption of rule 145 raises the question whether the states should reconsider this blue sky treatment. Such a reconsideration must focus on current blue sky practice and policy with regard to reorganization-issued securities.

A fundamental difference between state and federal securities regulation must be taken into account in the reassessment of state securities law on reorganizations. The federal securities laws require, in most instances, only the disclosure of what Congress intentions: SEC Rule 145, supra note 5, at 946-48. The completed Form S-14 may not be suitable, however, for use in subsequent resales, because much of the information in them is irrelevant once the plan of reorganization has been approved and the transaction has taken place. It has been suggested that the SEC establish procedures for simplifying and streamlining Form S-14 for use in resales. Schneider & Manko, supra note 5, at 822.

73. The rule has been criticized, however. One major concern is its assignment of underwriter status to controlling persons of acquired corporations in mergers, consolidations, and sales of assets, while those persons in a tender-offer reorganization may not as readily be classified as underwriters. See notes 61-62 supra and accompanying text. For a discussion of the problems inherent in rule 145, see Schneider & Manko, supra note 5, at 996-99; Note, Business Combinations and Registration Requirements: SEC Rule 145, supra note 5, at 948-57.

74. See notes 86-87, 93-133 infra and accompanying text.
75. See notes 113-33 infra and accompanying text.
76. See Draftsmen's Commentary to USA § 401(j), in Loss & Cowett 346-47. See also text accompanying note 93 infra.
and the SEC believe is the information necessary for an informed investor choice in the marketplace.\textsuperscript{77} In contrast, the blue sky law postulate is that mere disclosure of information is not enough to ensure adequate investor protection and that a critical administrative review should be made into the underlying quality of a security before it can lawfully be sold within the state.\textsuperscript{78} Thus, as a condition to approving blue sky registration, the state securities administrator requires that the proposed issuance of securities meet certain qualitative, statutory standards.\textsuperscript{79} This blue sky law philosophy has come to be known as "state paternalism".\textsuperscript{80} Although the resources of state agencies are often too limited to conduct extensive evaluations of securities, this approach requires substantially more than the disclosure of information that is sufficient under the federal law.\textsuperscript{81}

Occasionally the distinction between federal and blue sky philosophies blurs. For example, under section 8(a) of the Securities Act, the SEC may deny acceleration of effectiveness of a registration statement pursuant to a standard of "due regard"


\textsuperscript{78} See 1 Loss 57-61, 121-128; Hueni, Application of Merit Requirements in State Securities Regulation, 15 Wayne L. Rev. 1417 (1969).

\textsuperscript{79} While most blue sky laws afford some statutory basis for a critical administrative inquiry into the quality of the security, the statutory standards and the attendant degree of administrative discretion may vary from one jurisdiction to another. Standards such as "sound business principles," "grossly unfair terms," and "fair, just and equitable," have been said to "leave a good deal to the administrator's imagination." Loss & Cowerett 67. To help avoid the confusion that can arise under such broad standards, the Commissioner of the Ohio Division of Securities has established written policy guidelines with regard to determinations made under its "grossly unfair terms" standard. Omow Securities Bull., June 1973, at 10. The Uniform Securities Act limits administrative discretion somewhat through fairly specific standards. See USA § 306(a). Only a few areas appear to be left open to what was the traditional exercise of administrative discretion. See USA §§ 306(a)(2)(E), (F). Draftsmen's Commentary to § 306(a), in Loss & Cowerett 328-29. See generally Loss & Cowerett 67-79 (1958).


\textsuperscript{81} While administrative evaluation of securities issues continues to be the focus of blue sky statutes, difficulties such as inadequate budgets and personnel and uneven enforcement probably result in less "paternalism" in most states than the blue sky laws intended. See Loss & Cowerett 37, 43-86. Notwithstanding these difficulties, current blue sky laws completely ignore this paternalistic philosophy in the current treatment of securities issued in corporate reorganizations. See text accompanying notes 118-23, 135, 171-72 infra.
for “the public interest and the protection of investors.”82 This standard gives the SEC the kind of discretion that is typical of blue sky paternalism.83 On the other hand, the New York approach to the registration of intrastate offerings is simply disclosure oriented, not paternalistic,84 although the attorney general is authorized to exempt an intrastate offering if “such action is not inconsistent with the public interest or the protection of investors,”85 a paternalistic standard. Nonetheless, paternalism continues to be the hallmark of blue sky regulation, while the disclosure approach more properly characterizes federal regulation.

Under their respective blue sky laws, the vast majority of states generally follow one of two approaches with regard to the registration requirements of securities issued in statutory mergers, consolidations, and certain other corporate reorganizations. A significant number of states have adopted the approach of the Uniform Securities Act (USA), which expressly excludes these reorganizations from the definitions of “sale” and “offer.”86 Under this approach, both

83. Another example of SEC paternalism arises under section 15A of the Exchange Act, 15 U.S.C. § 780-3 (1970), which gives the SEC some control over unreasonable underwriter compensation. This section requires as a prerequisite to registration of a national securities association of brokers and dealers that the rules of the association be designed “to promote just and equitable principles of trade, [and] to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges.” 15 U.S.C. § 780-3 (b)(8) (1970). The National Association of Securities Dealers (NASD), the only registered association to date, has established a policy of allowing only “reasonable” underwriter compensation. See Interpretation of Article III, Section I of the NASD Rules of Fair Practice, CCH NASD MANUAL ¶ 2151, at 2023 (1971). In turn, an SEC guide to the preparation and filing of registration statements requires disclosure of all forms of underwriter compensation and a statement of whether the NASD has approved the underwriter compensation. See Guide 17 (Disclosure of Underwriting Discounts and Commissions) in SEC Guides for Preparation and Filing of Registration Statements, SEC Securities Act Release No. 4936 (Dec. 9, 1968). Thus, a blue sky type of “fair or reasonable” standard is incorporated into regulation at the federal level.
86. UNIFORM SECURITIES ACT § 401(j)(6) states:

The terms defined in this subsection ["sale", "sell", "offer" and "offer to sell"] do not include (A) . . . ; (B) . . . ; (C) any act incident to a class vote by stockholders, pursuant to the certificate of incorporation or the applicable corporation statute, on a merger, consolidation, reclassification of securities, or sale of corporate assets in consideration of the issuance of securities of another corporation; or (D) any act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securi-
the registration and the antifraud provisions of the blue sky laws may be inapplicable. An even greater number of states have adopted a second approach, which is to include the issue of securities through reorganizations within the statutory definition of "sale" but to exempt the reorganization transaction from registration. A few states


The transaction exemptions in these states may not always extend to the same corporate reorganizations. Some states limit the exemption to mergers and consolidations, while others extend it to sales of corporate assets, reclassifications, and reorganizations generally. For a reorganization not covered by the express language of the statute, a ruling on possible exemption status should be sought from the blue sky administrator. In several states, a favorable ruling will probably be given. See Bialkin, State Securities Laws, in 1 BUSINESS ACQUISITIONS: PLANNING AND PRACTICE 441, 444-45 (J. Herz & C. Ballew, eds. 1971).

Under the state securities acts, the party claiming exempt transaction status
take other approaches to regulation of reorganization-issued securities, including (1) administrative supervision by means of a fairness hearing on the plan of reorganization,88 (2) regulation by means of interpretive rulings,89 and (3) registration of the securities.90 The New Hampshire blue sky law represents one extreme in not requiring registration for any security, whether issued for cash or in a reorganization; its focus is on the regulation of brokers and dealers.91 At the other extreme, California has fairly demanding registration requirements that depend on an administrative finding of "fairness."92

A. The Uniform Securities Act and the Definitional Exclusion

The drafters of the USA excluded transfers of securities issued in certain corporate reorganizations from the definition of "sale" of a security.93 In so doing, they "intended to incorporate all of the SEC's traditional 'no sale theory.'"94 Although the SEC had limited its no-sale theory under rule 133 to eliminate registration only,95 the USA definitional exclusion extends to the fraudulent practices and civil liabilities provisions of the Act, as well as to the registration or a definitional exclusion bears the burden of proof that the reorganization qualifies. E.g., USA § 402(d); Conn. Gen. Stat. Ann. § 36-322(c) (1969); Mass. Gen. Laws Ann. ch. 110A, § 402(d) (Supp. 1972). The Draftsmen's Commentary to USA section 402(d) noted that in cases where the statute was silent, courts have placed the burden of proof on the party claiming the exemption. Loss & Cowett 381.

92. See notes 149-51, 158 infra and accompanying text. There is a limited exemption available under the California statute. See note 150 infra and accompanying text.
93. USA § 406(j)(6)(C).
94. See Draftsmen's Commentary to USA § 406(j), in Loss & Cowett 347.
95. See text accompanying notes 36-49 supra.
provisions. In short, the current USA philosophy is to leave re-
organizations unattended by the state securities laws.

The drafters offered several arguments to justify this extension
of the no-sale exclusion to the antifraud and civil liability provisions. First, they argued that very few existing blue sky laws contained
civil liability provisions applicable to these shareholder vote situa-
tions. They apparently believed that, to the extent the USA rep-
resents a codification of existing law, it should take a similar posi-
tion. Their solution was to specifically exclude reorganizations ap-
proved by shareholder vote from the coverage of the Act. Second,
they were reluctant to "disturb whatever jurisprudence now applies"
to these reorganizations under state corporate and general law by
placing mergers and consolidations within the ambit of the blue sky
law liability provisions as well. Third, they argued that, in con-
trast to the regulatory pattern at the federal level, where all the civil
and criminal remedies are available only by virtue of the federal se-
curities acts, the states already had available other statutory and
common law remedies (civil and criminal), including rescission,
deceit and obtaining property by false pretenses, which made
further remedies under the USA unnecessary. Finally, the drafters
argued that section 12(2) of the Securities Act and certain federal
criminal remedies would usually apply to these reorganizations when-
ever an instrument of interstate commerce was used, regardless of
whether or not the securities were registered under the blue sky
laws.

The reasons given by the USA drafters for the exclusion of
mergers, consolidations, and other reorganizations from both the an-
tifraud and the civil liability provisions are not convincing. Blue
sky law treatment of these transactions at the time of the drafting
of the Uniform Securities Act may not have justified exclusion from
the antifraud and civil liability provisions of the USA. The drafters
argued that the USA was only codifying current state practice in

96. Draftsmen's Commentary to USA § 406(j), in Loss & Cowett 347.
See generally Cowett, supra note 7, at 421; Jennings, supra note 80, at 218-
20, 228-30; Note, The Uniform Securities Act, 12 Stan. L. Rev. 103, 129-33
(1959). The fraudulent practices and civil liabilities provisions are USA §§
101 and 410(a)(12), respectively; the registration requirements are USA §§
302-05.

97. Draftsmen's Commentary to USA § 401(j), in Loss & Cowett 347.
98. Id.
99. Id.
100. Id.
The majority of blue sky laws purported to exempt some or all of these corporate events; they did not follow a definitional exclusion approach. If, as the drafters imply, these exemptions in fact extended to the civil liability provisions, then they were no different in effect from a definitional exclusion: both approaches remove these reorganization-issued securities from the substantive provisions of the blue sky law. The USA approach therefore would not have been without precedent. But it was questionable precedent at best. When carefully read, many of the exemptions apparently did not cover the corporate reorganizations eventually excluded by USA section 401(j)(6)(C). In an article postdating the drafting of the Act, Edward Cowett stated that, while more than 30 statutes purported to exempt these corporate events, a "closer examination reveals that the exemptions may be illusory in many instances." In short, state regulation of reorganization-issued securities was more complex than the drafters would have us believe. In fact, while the drafters argued that existing civil liability provisions did not apply here, Mr. Cowett concluded that many reorganization-issued securities had been issued in violation of the blue sky laws and thus had created "potential civil liability of substantial proportions."

Nonetheless, even assuming the drafters correctly characterized existing state law, the absence of civil liability provisions applicable to these shareholder-vote reorganizations in the blue sky laws should not have precluded the drafters from including such coverage in the USA. In areas of blue sky coverage where reform was needed, the USA drafters rewrote the law. For example, in USA section 101, the general antifraud provision, modeled after the SEC's Rule 10b-5, the drafters created liability for half-truths in the purchase or sale of securities. This liability for half-truths was not com-

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101. See Draftsmen's Commentary to § 401(j), in Loss & Cowett 347.
102. Id. at 346; Cowett, supra note 7, at 422.
103. The drafters state that "very few of the existing statutes contain civil liability provisions which apply in these class vote situations." Draftsmen's Commentary to § 401(j), in Loss & Cowett 347. Since they also state that a majority of statutes exempt some or all of the reorganizations covered by USA section 401(j)(6)(C) (id. at 346), it appears that the only way so few statutes could provide for civil liability in these situations is if the exemptions cut across the civil liability provisions as well as the registration provisions.
104. Cowett, supra note 7, at 423.
105. Id. at 427.
107. USA § 101(2). See Draftsmen's Commentary to § 101, in Loss & Cowett 251.
mon in existing blue sky laws.\textsuperscript{108} USA section 407 expanded the investigation and subpoena powers to give the administrator more authority than he typically had under existing statutes.\textsuperscript{109} The content of the registration statement required under section 304 was "spelled out more fully and specifically" than most registration statements then in use.\textsuperscript{110} Further, in drafting the civil liability provisions of section 410(a), the drafters sought to correct "one of the areas most in need of reform."\textsuperscript{111} Thus, reform was undertaken in instances where it was needed and could have been undertaken in the corporate reorganization context as well. Since mergers, consolidations, and other reorganizations may present serious investor protection concerns, these situations require at least that general antifraud and criminal remedies be available. Indeed, the federal experience under rule 133 led the SEC to conclude that much more was required, so that now substantial disclosure is demanded under rule 145. The rationales that failed to support the no-sale rule under federal practice cannot be used to support a broader application of that rule at the state level.

Second, the drafters' reluctance to "disturb whatever jurisprudence now applies" to reorganizations by allowing the civil liabilities provisions of the USA to cover reorganization-issued securities was unfounded. The imposition of the registration, antifraud, and civil liability provisions over nonexempt securities and transactions was found to be necessary in other contexts despite possible infringement of existing state law. Moreover, the antifraud and civil liability provisions continued to apply in the case of a security or transaction for which an exemption was available; the exemption applied only to the registration provisions. There, the disturbance of "whatever jurisprudence now applies" must have been considered necessary. It is difficult to understand why the inclusion of mergers and consolidations under these provisions would cause any greater disruption of current state corporate reorganization law than similar instances of securities regulation impose upon other areas of corporate law. Further, in some instances, the results reached under existing provisions of state corporate reorganization law were questionable and could

\textsuperscript{108} See Draftsmen's Commentary to § 101, in Loss & Cowett 251.

\textsuperscript{109} USA § 407. See Draftsmen's Commentary to § 407, in Loss & Cowett 386.

\textsuperscript{110} USA § 304(b). See Draftsmen's Commentary to § 304(b), in Loss & Cowett 304.

\textsuperscript{111} USA § 410(a). See Draftsmen's Commentary to § 410(a), in Loss & Cowett 390.
have been properly replaced with, *inter alia*, the civil liability provisions of the blue sky law. For example, a director or shareholder validation provision in a state corporation statute might have been used to validate the most suspect conflict-of-interest merger and foreclose any inquiry by complaining shareholders into the actual fairness of the reorganization.\(^{112}\) The close scrutiny of a judicial or administrative inquiry under provisions of a blue sky law would be an appropriate response to such questions. Thus the need for investor protection seems just as great in either case. Even if some disturbance of existing state law be assumed, it is clear that the drafters failed to show that the additional investor remedies and protection would not outweigh the disturbance.

Third, the existence of other state remedies should not have deterred the drafters from affording the protection of antifraud and civil liability provisions to reorganization-share recipients. The difficulties in obtaining relief under state statutory and common law often foil the legitimate plaintiff. For example, the plaintiff may have to prove scienter or reliance in an action at law for deceit,\(^ {113}\) while these burdens may properly be lessened under a state securities act.\(^ {114}\) In addition, where a claim can be brought only as a derivative action under state corporation law, the plaintiff will face several often insurmountable hurdles.\(^ {115}\) To remedy this situation, the registration, antifraud, and civil liability provisions of the USA should be extended to the statutory merger and consolidation transactions. The concurrent coverage of the existing state law remedies


114. *See*, e.g., Draftsmen’s Commentary to USA § 410(a), in *Loss & Cow*.

115. These hurdles include the “contemporaneous share ownership” requirement, the posting of security for litigation expenses (or possible reimbursement of defendants’ expenses even where security is not required before the litigation), short statutes of limitations for some types of actions against management, shareholder validation statutes and case law, requirements of prior demand on the board of directors and/or shareholders, unresolved questions of standing to sue in the merger and consolidation situations and general judicial deference to management decisions under the “sound business judgment” rule. *See* H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* §§ 352-72 (1970).
and additional securities law provisions that exist in the case of other securities issues should not be objectionable in issues through reorganizations.

Fourth, the drafters reach too far in arguing that state securities law remedies are unnecessary in view of the availability of federal civil and criminal remedies when the jurisdictional means are used. If the availability of federal remedies obviates the need for registration or antifraud remedies in a merger, consolidation, or sale of assets, all transactions which produce many of the same investor protection concerns that are present in the cash-for-stock issuance, then logically state registration and antifraud protection would also be unnecessary in all other transactions presently covered by the federal securities laws.

Even if the USA had excluded reorganization issues from the definition of "sale" only for purposes of registration, that decision would now have to be reconsidered. The drafters commented that in USA section 401(j)(6)(C) they were adopting the SEC's no-sale theory, which was based on the "corporate action," as opposed to the "individual volition," view of the security holders' decision to approve a plan of merger or consolidation.\(^{116}\) This rationale is not tenable in view of the decisions an individual shareholder must make: first, how to vote, and second, whether to exercise dissenter's rights. The rationale was criticized throughout the history of SEC rule 133 and rejected in practice by rule 145.\(^{117}\)

A more basic flaw exists in the approach taken by the USA toward statutory mergers and consolidations. The position of the USA with regard to these organizations is contrary to the paternalistic philosophy of blue sky law regulation.\(^ {118}\) State common law generally has little or no prophylactic effect. The blue sky laws were designed to solve this problem. Yet by allowing the issuer to avoid registration in a merger or consolidation, and by relegating the disappointed investor to after-the-fact fraud remedies, the state fails to take the preventive measures in these reorganization contexts that it takes in subjecting other securities issues to a critical, qualitative

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116. The USA definitions of "sale" and "offer" include the "for value" element found in the Securities Act section 2(3) definition. USA § 401(j)(1), (2). These definitions thus seem to afford a statutory basis for raising the "volition-value" argument at the state level as it was at the federal level. See notes 30-36 supra and accompanying text.
117. See text accompanying notes 37-65 supra.
118. See text accompanying notes 77-85 supra.
review before registration is approved. Thus by definitionally excluding from blue sky law coverage issues through reorganizations, the drafters of the USA abandoned the state policy of initially preventing the sale of undesirable securities. Given the history of abuse of the merger and consolidation as a means of passing large quantities of questionable securities on to the investing public, these reorganizations seem to call for the critical administrative inquiry that is basic to blue sky regulation. This review is particularly necessary where the issuance of securities is not subject to the federal registration provisions, as where an intrastate, or private offering exemption is available at the federal level. Here, a state administrative inquiry will be the only pre-issuance safeguard covering such securities.

B. Exempt Transaction Treatment Under the Blue Sky Laws

A blue sky exemption for securities issued in reorganizations typically exempts the securities from registration only—not from the antifraud provisions. In giving the exemption for registration only, the states reach much the same result as the SEC did in limiting its no-sale rule so as to obviate registration while leaving the anti-

119. But administrative discretion under the USA is less than that available under the "fairness" standard under other blue sky laws. See note 79 supra.
120. See text accompanying notes 17-50 supra.
122. Under § 3(b) of the Securities Act, the SEC has the power to exempt offerings of less than $500,000 in value, 15 U.S.C. § 77c(b) (1970), and the Commission did so by promulgating Regulation A. SEC Reg. A, 17 C.F.R. §§ 230.251-263 (1972).
124. See generally Official Comment to § 402(a) and Draftsmen’s Commentary to § 402(a), in Loss & Cowett 352-53. A few states exempt some transactions from all of the provisions of the blue sky law, including the civil liability and antifraud provisions. See, e.g., Va. Code Ann., § 13.1-514(c)(2) (Supp. 1974), which exempts from all provisions of the act “any transaction incident to a right of conversion or a statutory or judicially approved reclassification, recapitalization, reorganization, quasi-reorganization, stock split, reverse stock split, merger, consolidation or sale of assets.” The practical effect of such all-encompassing exemptions is the same as that of the definitional exclusion approach of the Uniform Securities Act. The broad Virginia exemption is subject to one qualification, however:

Notwithstanding the provisions of subsection (c)(2), the merger or consolidation of corporations shall be a violation of this chapter if the surviving or new corporation has more than thirty security holders and all the securities of the parties thereto were issued under
fraud provisions in effect. Thus, while the definitional exclusion of these reorganizations from the USA was said by the drafters to be an adoption of the SEC's no-sale theory, the exempt transaction approach may be closer to SEC practice under rule 133.

In fact, rule 133 may have been narrower than present exempt-transaction provisions in the blue sky laws. Not only did the SEC limit the rule 133 exemption to the registration provisions of the Securities Act, but it also refused to allow the exemption in situations where security-holder control made a vote on a plan of merger or consolidation a "mere formality," where the reorganization was part of a two-step scheme to distribute securities to the public without registration, where security holders were offered a choice of securities in the transaction, or where unanimous shareholder approval was a condition to the reorganization. On the blue sky side, there is no indication that such limitations are in effect in any of the states that have adopted the exempt transaction approach. However, the administrator's discretionary power to deny or revoke the exemption of issues in a merger or consolidation could probably be used to achieve a similar result. For example, the Alabama blue sky law gives exempt transaction status to certain reorganizations and reclassifications but, at the same time, provides the administrator with the power to revoke or deny the exemption where he finds that the sale of given securities would defraud the purchaser. It would not be unprecedented in blue sky regulation to interpret "defraud" more broadly than common law deceit and thus give additional discretion to the administrator. However, notwithstanding the avail-

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125. See text accompanying notes 36-53 supra.
126. See text accompanying notes 36-49 supra.
127. Ala. Code tit. 53, § 38(n) (Cum. Supp. 1973). Other blue sky laws have a similar provision. This type of sanction may be applied to one or more specific securities and/or transactions otherwise exempt under the particular blue sky law. Application varies somewhat from jurisdiction to jurisdiction. A few jurisdictions give the blue sky administrator this power over all or most of the exemption provisions. See, e.g., Minn. Stat. Ann. ch. 451, § 15(1) (1973). For the comparable USA provisions and comments, see Loss & Covett 379-80. The blue sky administrator typically has other weapons he can bring to bear against an offer or sale of suspect securities, including investigatory, subpoena, and injunctive powers. See, e.g., Minn. Stat. Ann. ch. 451, §§ 20, 21 (1973).
128. See USA § 401(d); Official Comment and Draftsmen's Commentary to § 401(d), in Loss & Covett 337-38; see also USA § 306(a)(2)(E); Offi-
ability of this administrative power, the transaction exemption allowed under the blue sky laws has broader application to corporate reorganizations than did the exemption afforded by the SEC under rule 133.

Though exemptions free the issuer from assessment of the securities by the blue sky administrator, qualifying for these exemptions may still pose a problem. The party claiming the exemption has the burden of proving its applicability,\(^\text{129}\) and the lack of uniform requirements from state to state makes this task difficult.\(^\text{130}\) There are differences in the forms used, the information requested by the state, and the procedures to be followed in establishing exempt transaction status for the reorganization or in registering the security if such status is not sought.\(^\text{131}\) In addition, the exercise of the power of the administrator to deny or revoke the exemption\(^\text{132}\) may vary

\(^{129}\) See note 87 supra.

\(^{130}\) Not only may formal blue sky law requirements and procedures vary from state to state, but success with the blue sky administration may depend upon familiarity with informal, unpublished administrative practices and some knowledge of how to secure and use administration assistance. Loss & Cowett 44. Loss and Cowett conclude that “the practice of blue sky law has become a highly specialized art. Only those lawyers who devote a substantial amount of their practice to blue sky matters develop the expertise necessary to bring order out of the statutory and administrative morass.” Id. Indeed, achieving simultaneous federal and state effectiveness has been described as a “minor miracle.” Cowett, supra note 80, at 296. See generally Loss & Cowett 43-128.

\(^{131}\) For example, Iowa requires that the proposed plan of merger or consolidation be approved by the commissioner of insurance, and the commissioner may demand any information he deems necessary to help him make that decision. IOWA CODE ANN. § 502.5(6) (Supp. 1974). The Kansas administrator will approve an exemption for a merger or consolidation only where the issuer files notice detailing the terms of the offer and “such other information as the commissioner may require.” KAN. STAT. ANN. § 17-1262(l) (Supp. 1972). Following such disclosure, the exemption is effective “if the commissioner does not by order disallow the exemption within thirty days.” Id. Similarly, Minnesota requires that the commissioner be provided with a description of the plan of merger or consolidation and “other information as he prescribes by rule . . . .” MINN. STAT. ANN. ch. 451, § 15(2)(l) (1973). Virginia modifies in one statutory subsection (VA. CODE ANN. § 13.1-514(b)(8) (Supp. 1974)) what seems to be a broad exemption for mergers and consolidations granted in another subsection (VA. CODE ANN. § 13.1-514(c)(2) (Supp. 1974)). See note 124 supra. Texas has added the proviso that the shareholders must not be required to pay any consideration beyond the surrender of the security of the decedent corporation. TEX. REV. CIV. STAT. ANN. § 581-5(G) (1964). Other minor variations of exempt transaction treatment of statutory mergers and consolidations can be found throughout the blue sky laws.

\(^{132}\) See note 127 supra. Blue sky administrators also have the power to
from a practice of benign neglect to strict scrutiny of the corporate events taking place under the exemption. Finally, the scope of the exemption varies among the states, so that some reorganizations—for example, a sale of substantially all the assets of one corporation for the stock of another—will be exempt under some statutes and not others. This factor diminishes the benefit of exemptions that do apply for multistate offerings.

By granting reorganization-issued securities an unwarranted exemption, the states have in effect abandoned the preventive paternalistic inquiry into the quality of the security and relegated the investor to after-the-fact fraud remedies. The exempt transaction approach to regulation of reorganization-issued securities, like the USA definitional exclusion, fails to afford full blue sky investor protection in a situation in which it is needed. Although under most of the exemptions the civil liability and antifraud provisions will be applicable to these securities, shareholders who may participate in a reorganization exchange would benefit from the blue sky administrative review. A blue sky exemption should be made available only where it is reasonably certain that investor concerns will not arise or where an alternative source of regulation can assure an adequate, comparable level of investor protection. This is not the case in most corporate reorganizations.

revoking or suspending a registration of securities, but the power may be seldom exercised. Less formal action is usually taken where the administrator objects, for whatever reason, to the proposed issue. Loss & Cowett 80-81.

133. With regard to exemptions generally available under the blue sky laws, Loss and Cowett note that "[t]he word 'exemptions' opens a big subject, because they are manifold and variegated. . . . [H]ere, too, statutory language is sometimes one thing and administrative practice another." Loss & Cowett 81. The cautious practitioner will nonetheless look beyond administrative practice to the ultimate question of liability:

[Even though the administrator turns his head the other way, the statute more likely than not declares that all sales in violation of any of its provisions are voidable. Indeed, the courts are apt to say so even if the statute does not. And, regardless of the administrator's policy not to enforce the statute in certain cases, or his inability to do so as a practical matter, the courts in civil actions will have to take the statute as they find it. This is one of the sources of innocently assumed contingent civil liabilities. . . .

Id. at 83.

134. See note 87 supra.

135. Ideally, an exemption will not be available to cover securities or transactions that are completely unregulated. Banks, insurance companies, public utilities, interstate carriers, and certain other types of corporations may be given securities exemptions because separate regulatory agencies oversee their activities. See, e.g., Securities Act §§ 3(a)(2), (5), (6), (8), 15 U.S.C. §§ 77c(a)(2), (5), (6), (8) (1972); USA §§ 402(a)(3), (4), (5), (6),
A second type of exemption is one from registration following administrative “fairness” hearings on the proposed plan of reorganizations. Ohio has such a provision, though its availability is limited. A corporation that is organized under the laws of Ohio or has its principal place of business in Ohio may request a hearing before the Ohio Division of Securities. The Division may approve the terms of the issuance and exchange of securities under the proposed plan of reorganization, and those securities are then exempt from registration under the Ohio Securities Act. The importance of these exemptions for judicially or administratively

(7). Most states exempt securities listed on major exchanges, presumably because the listing requirements and continued exchange supervision sufficiently protect the investor. See USA § 402(a)(8). Transaction exemptions may be available for similar reasons, as where certain non-issuer distributions are allowed if (A) a recognized securities manual contains specified information about the issuer; or (B) the security has a fixed maturity, interest, or dividend provision and has no recent record of payment default. See USA § 402(b)(2). Other exemptions may have a more practical basis, as where the USA temporarily and conditionally exempts preincorporation subscriptions because of the preliminary nature of the undertaking and information. USA § 402(b)(10). Not all such exemptions will have a reasonable basis in fact; the alternative regulation or lack of investor concern may not really be there. See SEC v. Variable Annuity Co., 359 U.S. 65, 77-80 (1959) (Brennan, J., concurring) (no federal exemption for variable annuity contracts because state regulation inadequate). In the tentative draft of the ALI Federal Securities Code, Professor Loss has narrowed the current exemption for bank securities to cover only depositors' accounts or their equivalent. ALI FED. SEC. CODE § 301 (Tent. Draft No. 1, April 25, 1972). The current exemption (Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(7) (1970)) exempts all bank securities. See generally R.W. JENNINGS & H. MARSH, JR., SECURITIES REGULATION: CASES AND MATERIALS, 603-04, 610-12 (1972); LOSS & COWETT 81-83.


137. OHIO REV. CODE ANN. § 1707.04 (Page 1964). See note 142 infra. Professor Loss describes the similar Ohio, California, Indiana, and Wisconsin provisions as “going to the other extreme of providing special administrative procedures” when compared to the exemption or exclusion approach. 1 Loss 539-40. An Ohio exemption created by an administrative ruling that has since been repealed once undermined the usefulness of the Ohio provision. See text accompanying notes 152-57 infra.


139. Id. If no transaction exemption, definitional exclusion, or fairness hearing exemption is available at the state level, the issuer may still qualify for another exemption, for example, if his security is listed or approved for listing upon a qualified stock exchange (see, e.g., USA § 402(a)(8)), or if the issuer is a bank, savings and loan association, insurance company, credit union, railroad, common carrier or public utility, all of which are regulated by separate state or federal agencies (see, e.g., USA §§ 402(a)(3)-(7)).
supervised reorganizations may be substantial in light of SEC rule 145. For example, the administrative hearing under the Ohio Securities Act apparently meets the requirements of the official hearing and approval needed for an exemption under section 3(a)(10) of the Securities Act. Since the securities practitioner may want to use the section 3(a)(10) exemption to avoid federal registration, now required under rule 145, the administrative hearing procedure may get much more use than it has in the past.

From the standpoint of federal and state regulatory policies, there are some difficulties with the fairness hearing approach. It allows a single blue sky administrator to cut away at will the dis-


142. Blue sky administrators may become much less willing to grant the fairness hearing. The Commissioner of the Ohio Division of Securities recently concluded that:

in light of the principles underlying Section 3(a)(10), the regulatory interests and the manpower resources of the Division, and the widespread existence of market preconditioning (gun jumping) in connection with reorganization transactions for which applications have been made in the past, the exercise of its discretion in the granting of fairness hearings should, as a matter of policy, be restricted to transactions which are particularly suitable for determination by this agency.

OHIO SECURITIES BULL., June 1973, at 5. A proposed new Ohio Securities Act does not contain a provision comparable to Ohio Revised Code § 1707.04, reflecting "the opinion of the Division that this provision does not involve a sufficiently important regulatory interest to justify a commitment of the additional manpower resources required for this type of proceeding." Id. If the Ohio fairness hearing is available, it can result in exemptions for both state and federal registration. The California fairness hearing, however, generally occurs in connection with registration at the state level, so only a federal exemption can be secured through this procedure. CAL. CORP. CODE § 25142 (West Supp. 1974); CAL. ADMIN. CODE tit. 10, ch. 3, as amended, Rule No. 260.140-.62 (1969), 1 BLUE SKY L. REP. ¶ 8622 (1973). The California statute will permit the use of a hearing even where the security or transaction is otherwise exempt from the permit qualification requirement. CAL. CORP. CODE § 25142 (West Supp. 1974); see Draftsmen's Commentary to the 1968 California Corporation Code, in H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968, at 580-81; Glickman, supra note 136, at 655-56.
closure protection of the Securities Act for all other states in which the securities will be distributed. Unless the administrator requires the dissemination of structured information to the offerees as an element of the fairness determination,¹⁴³ the federal regulatory scheme is accepting a process that ignores disclosure to investors.¹⁴⁴

There are practical difficulties as well. In order to secure the section 3(a)(10) exemption, an issuer may attempt to use the fairness hearing of a state with which it has no substantial connection, and that state may in fact grant rather perfunctory approval of the reorganization exchange.¹⁴⁵ The state may also lack the personnel and budget to conduct an adequate inquiry at a hearing;¹⁴⁶ thus the proceeding may become largely ex parte, to the detriment of the interests of the investors. For these reasons, at least one commentator has suggested that the section 3(a)(10) exemption be abolished.¹⁴⁷

Generally, blue sky administrators have the power to issue interpretive rulings on the scope or applicability of transaction exemptions. Though that power is not often used,¹⁴⁸ there are occasional exceptions. In California, a state which does not broadly exempt or exclude most reorganizations from registration,¹⁴⁹ the commissioner has used his rulemaking authority to add to a limited statutory exemption. By statute, California exempts from registration the issue of securities in a reorganization where fewer than 25

¹⁴³. The Ohio Division of Securities has concluded that offerees in the exchange of securities must be given "adequate disclosure documents which will be subject to Division approval." OHIO SECURITIES BULL., June 1973, at 5.

¹⁴⁴. See Glickman, supra note 136, at 663-64.


¹⁴⁶. See Glickman, supra note 136, at 651-53.

¹⁴⁷. Id. at 663-64. Of course, if the issuer does secure a section 3(a)(10) exemption, the opportunity to use the registration-by-coordination provisions available in many blue sky jurisdictions (see USA § 303 and note 169 infra) will be lost. But that difficulty arises only if registration of the reorganization is necessary at the state level in the first place. Typically, such registration is not required. See notes 86-135 supra and accompanying text.

¹⁴⁸. Loss & Cowett 44. Although these authors' observations were made in 1958, there has been relatively little added by way of administrative ruling or interpretation in the intervening years.

¹⁴⁹. Registration requirements generally apply to reorganizations in California, and the commissioner has promulgated a number of rules pertaining to the granting of a qualification permit to issue reorganization securities. See notes 158-61 infra and accompanying text. The permit qualification requirement for recapitalizations and reorganizations is set forth in CAL. CORP. CODE § 25120 (West Supp. 1974).
percent of the shares to be exchanged are held by California residents.\textsuperscript{150} The commissioner has extended this exemption to a reorganization involving a parent company and a wholly owned subsidiary by ruling that the same exemption will be available when the issuer of the securities is a corporation holding all the stock of the surviving, consolidated, or purchasing corporation.\textsuperscript{151}

The Ohio experience in exempting mergers and consolidations under a 1938 administrative ruling is an interesting case study in the use of administrative power to create an exemption through interpretation of a blue sky law. Until 1971, the Ohio administrator did not require registration of securities issued for statutory mergers and consolidations, under an administrative ruling interpreting Ohio Revised Code section 1707.03(K)(2), which exempts from registration the distribution or exchange by a corporation of its securities with its shareholders.\textsuperscript{152} The subsection does not appear to apply to

150. \textit{Cal. Corp. Code} § 25103(c) (West Supp. 1974). The exemption is further narrowed by defining "outstanding shares" as \textit{not} including either securities controlled by a person who controls 50 percent or more of that class of securities or securities which the issuer knows to be held by broker dealers in street name accounts. \textit{Cal. Corp. Code} § 25103(d) (West Supp. 1974).


152. The exemption covers "the exchange of any security by the issuer exclusively with its existing security holders, where no commission or other remuneration is given directly or indirectly for soliciting such exchange . . . ." \textit{Ohio Rev. Code Ann.} § 1707.03(k)(2) (Page 1964).

The ruling read as follows:

\textbf{RULING 2-R.C. § 1707.03(K)—EXCHANGE OF SECURITIES OF MERGED OR CONSOLIDATED CORPORATIONS}

\textbf{FACTS—}Two domestic corporations are to be consolidated under the provisions of the General Corporation Act of Ohio. The resultant corporation will issue its securities to the shareholders of the constituent corporations in exchange for the securities of such corporations held by such shareholders.

\textbf{QUESTION—}(1) Can an exemption be claimed under the provisions of R.C. § 1707.03(K)?

\textbf{...}

(3) Would the answer be different if there is a merger instead of a consolidation?

\textbf{RULING—}(1) The Corporation Act provides that all the debts, liabilities and duties of the respective constituent corporations shall attach to the consolidated corporation (R.C. § 1701.81). The consolidated corporation may enforce stock subscription agreements against subscribers to shares in the constituent corporations. It appears, therefore, that the transaction exemption provided in R.C. § 1707.03(K) may be claimed with respect to an exchange by the consolidated corporation for the shares of the constituent corporations.

(3) The above ruling would not be changed by the fact that a
the exchange of securities of an acquiring corporation in a merger for the securities of the shareholders of an acquired corporation.\textsuperscript{153} Nor does it cover the exchanges involved in a consolidation.\textsuperscript{154} The section does not require, or even mention, a shareholder class vote approving the plan of reorganization.\textsuperscript{155} Nonetheless, the Ohio Division of Securities ruled that the exemption could be claimed with respect to the exchange involved in a merger or consolidation.\textsuperscript{156} The ruling obtained a result similar to rule 133 from a statutory section that did not deal with the corporate events subject to rule 133 treatment. After more than three decades of practice under this administrative ruling, the Division of Securities concluded in a 1971 policy statement that this interpretation of the statutory language was incorrect, that no exemption should be allowed, and that registration of securities issued in these reorganizations would therefore be required in Ohio.\textsuperscript{157}

\textbf{C. Alternative Blue Sky Schemes for Regulation of Securities Issued in Reorganizations}

A handful of states do not follow either the definitional exclusion merger is effected rather than a consolidation. The Corporation Act does not distinguish between mergers and consolidations in any manner which would affect the reasoning of Part (1) of this ruling. Ohio Div. of Securities, Administrative Ruling No. 2, 2 BLUE SKY L. REP. \textsuperscript{153} at 38,702 (1970) (rescinded, effective June 23, 1971).

\textsuperscript{153} "Blue Sky" Regulations Statement Issued by Ohio Division of Securities, 44 OHIO B. ASS'N REP. 1075, 1076-79 (Sept. 20, 1971).

\textsuperscript{154} Id.

155. The subsection is virtually identical, in fact, to section 3(a)(9) of the Securities Act (15 U.S.C. § 77c(a)(9) (1970)), which provides an exemption for a corporate exchange of securities with its existing security holders where no commission is to be paid for soliciting the exchange. See note 36 supra. Section 3(a)(9) was not intended to exempt securities issued in a merger or consolidation. See "Blue Sky" Regulations Statement, supra note 153, at 1077; note 36 supra and accompanying text.


157. A comprehensive analysis of the problems involved in this Ohio administrative ruling is found in a statement of the Ohio Division of Securities on its policy regarding the sale of securities in a merger or consolidation. The statement is reprinted as "Blue Sky" Regulations Statement, supra note 153.

At the time of the policy statement, the Division stated that it would take a "no action" position with regard to issuers who continued to rely upon the administrative ruling in effecting a merger or consolidation until the Division published its "final conclusions" regarding these reorganizations. \textit{Id.} at 1081. The Division recently rescinded this no-action position. Registration and licensing generally have been required in these transactions as of January 1, 1974. \textit{Ohio Securities Bull.}, Sept. 1973, at 2-3, 4. The administrative fairness hearing approach under Ohio Revised Code § 1707.04 may be available in limited circumstances. \textit{See} notes 136-42 supra and accompanying text.
approach or exempt transaction approach to corporate reorganizations taken by the vast majority of blue sky jurisdictions. These alternative approaches can be examined to see if and how they deal with the difficulties that exist under the more prevalent blue sky treatments; of interest here are the regulatory schemes of California and Pennsylvania and an approach taken in a proposed revision of the Ohio Securities Act.

California affords these reorganization issues the full review it gives to other nonexempt distributions of securities, unless fewer than 25 percent of the shares involved are held by California residents. Therefore, these issues must qualify for the permit required under the statute. The permit is granted only if the commissioner decides after close scrutiny that the reorganization is "fair, just, and equitable." The commissioner has adopted strict rules for proxy solicitation, disclosure of information, and other conditions to the granting of a permit. One rule provides that the commissioner may condition the grant of the permit on the "affirmative vote of a specified percentage of the outstanding stock held by persons other than those who have a conflict of interest in connection with the adoption of the plan of reorganization." Under rules containing undefined terms such as "conflict of interest" the commissioner thus retains a great deal of discretion and can impose stringent requirements on an issuer.

The California approach views the problems present in reorganizations as the proper subject of blue sky paternalistic inquiry.


160. Rule No. 260.140.61, supra note 159.

161. California's comprehensive scheme of administrative supervision of qualification by permit of securities issued in recapitalizations and reorganization...
Inherent in its position is the judgment that mere disclosure, the basis of the federal securities laws, does not suffice for reorganizations any more than it does for other issues.\textsuperscript{162} In contrast, Pennsylvania and the proposed Ohio Securities Act exempt reorganization issues of securities from registration if disclosure is ensured. Pennsylvania's securities act,\textsuperscript{103} while modeled in part after the Uniform Securities Act, does not follow the USA definitional exclusion treatment of securities issued in corporate reorganizations. The Pennsylvania statute creates instead an exemption for securities issued in mergers, consolidations, and certain other reorganizations if one of two conditions is met: one party to the transaction either (1) must file proxy materials under section 14(a) of the Exchange Act, if that party is required or permitted to do so, at least 10 days prior to the shareholder meeting at which the plan of reorganization is to be presented and must see that these proxy materials are distributed to the shareholders of the corporations involved; or (2) must submit such materials as the Pennsylvania Commissioner may require by regulation, and upon approval by the Commissioner, must distribute these materials to the security holders of the corporations involved.\textsuperscript{164} (When applicable, new SEC rule 145 requires that...}

\textsuperscript{1} See generally Cowett, supra note 80; Loss, Developments in Blue Sky Laws, 14 Bus. Law. 1161, 1164 (1959); Symposium, The Operation and Effectiveness of Blue Sky Legislation, 15 Wayne L. Rev. 1401 (1969).


\textsuperscript{3} Pa. Stat. Ann. tit. 70, § 1-203(o) (Supp. 1974). The subsection also allows a limited exemption, similar to the exemption available in California...
such materials be prepared and distributed.\(^{165}\)

A similar, but less rigorous, blue sky exemption is allowed under the proposed revision of the Ohio Securities Act,\(^{166}\) currently in committee before the Ohio General Assembly. Under the proposal, statutory mergers and consolidations will be exempt from the registration requirements of the statute with respect to reorganizations, reclassifications and similar transactions required to be submitted to a shareholder vote, only if one of two conditions is satisfied: (1) the securities are registered under the Securities Act; or (2) information "substantially equivalent" to a proxy statement or information statement required under section 14 of the Exchange Act is submitted to the shareholders at least 20 days prior to the shareholder meeting or the date of the transaction if no meeting is held.\(^{167}\)

The effect of the current Pennsylvania and proposed Ohio exempt transaction provisions is to achieve a standard of disclosure that assures some minimum level of investor protection during these corporate events and, at the same time, to lighten the burden of the blue sky practitioner by adding a much greater degree of uniformity and coordination between the blue sky procedures and federal procedures, especially under SEC rule 145. It is this type of simplification and streamlining of blue sky procedures that the drafters of the Uniform Securities Act were seeking in the Act's provisions for "registration by coordination" with the Securities Act of 1933.\(^{168}\) Similar registration by coordination provisions have been adopted in many state securities acts.\(^{169}\) But the Uniform Securities Act reg-

\(^{165}\) See note 85 supra and accompanying text, whereby the filing requirements do not apply if fewer than 25 percent of the security holders are residents of the state. Id.

\(^{166}\) See notes 70-72 supra and accompanying text.


\(^{168}\) See, e.g., ALA. CODE tit. 53, § 32 (Cum. Supp. 1974); ALASKA STAT. § 45.55.090 (Supp. 1973); ARK. STAT. ANN. § 67-1243 (1966); COLO. REV. STAT. ANN. § 125-1-8 (1963); DEL. CODE ANN. tit. 6, § 7305 (1973); FLA. STAT. ANN. § 517.08 (1972); HAWAIi REV. STAT. § 485-11 (1968); IDAHO CODE § 30-1420 (1967); ILL. ANN. STAT. ch. 121\(\frac{1}{2}\), § 137.5(B) (Smith-Hurd Supp. 1974); IND. ANN. STAT. § 23-2-1-4 (1972); KAN. STAT. ANN. § 17-1237 (1964); KY. REV. STAT. § 292.360 (1969); MD. ANN. CODE art. 32A, § 21 (1971); MASS. GEN. LAWS ANN. ch. 110A, § 302 (Supp. 1972); MICH. COMP. LAWS ANN. § 451.703 (1967); MO. ANN. STAT. § 409.303 (Supp.
istration by coordination requires registration at the state level, while the Pennsylvania and proposed Ohio provisions exempt the transactions from state registration altogether.¹⁷⁰ Moreover, as the draftsmen's comments to USA section 303 indicate, registration by coordination was meant only to streamline the content and procedure required for effectiveness, not to intrude upon the substantive standards governing that effectiveness.¹⁷¹ Yet both the Pennsylvania and proposed Ohio provisions will provide a complete exemption, if their requirements are met, and completely remove mergers and consolidations from the application of any substantive standards of review. Thus, they essentially abandon the substantive review and the critical value judgments characteristic of blue sky law paternalism for an approach requiring only disclosure of information. It must be recognized that this is a basic departure from blue sky

¹⁷⁰ However, the Pennsylvania Securities Act requires that the proxy or other required materials be filed with the Commissioner (PA. STAT. ANN. tit. 70, §§ 203(o)(i), (ii) (Supp. 1974)), and could, in practice, be little different from registration by coordination under the Uniform Securities Act. If substantive standards of review are applied to such materials to determine whether or not the exemption is effective, there is essentially no exemption provided at all. Cf. Official Comment and Draftsmen's Commentary to USA § 303(a), in Loss & COWETT 290-92. But the Pennsylvania statute seems to anticipate pro forma approval by the Commissioner when the materials filed give the information required under the statute; it does not explicitly call for a substantial inquiry or "fairness" determination. The proposed Ohio provision requires only that the proxy materials or their substantial equivalent be distributed to the security holders prior to the vote on the plan of reorganization. The exemption does not require a filing of materials with the administrator and therefore does not provide for any administrative review. See text accompanying notes 166-67 supra. Thus, the proposed Ohio exemption seems to be broader than the Pennsylvania provision in theory; in practice, the difference is likely to be quite minimal, perhaps even nonexistent, if the Pennsylvania administrator carries out merely a pro forma review, or no review at all.

¹⁷¹ Official Comment to USA § 303(a), in Loss & COWETT 290. See also Draftsmen's Commentary to USA § 303(a), in Loss & COWETT 290-92. But under the Pennsylvania statute, the "commission may by order deny or revoke" the exemption. PA. STAT. ANN. tit. 70, § 1-204 (Supp. 1974). Under the proposed Ohio Securities Act, the Commissioner "may by rule modify or further condition" the exemption. Proposed new Ohio Securities Act § 1707-06, S.B. 338, 110th Ohio Gen. Assembly, Reg. Sess. (1973-74). These powers can be used if there is an abuse of the exemption.
tradition. Apparently, the Pennsylvania and proposed Ohio securities acts have recognized the flaws in the reasoning that would completely exempt or exclude securities issued in statutory mergers, consolidations, and certain other reorganizations from statutory coverage. Though no disclosure is generally required by the states, these acts now at least require that certain information be made available to shareholders before they vote on a plan of reorganization.

The disclosure requirements of Pennsylvania and Ohio must be based on a recognition that investors need protection in the reorganization context as well as in exchanges of cash for securities. But it then follows that these states should enact full administrative review.

When the SEC reversed administrative practice under rule 133 by adopting rule 145, no challenge was made to the nature of federal inquiry and review. Rule 145 requires only disclosure, and disclosure has always been the foundation of federal securities regulation. But in the Pennsylvania and proposed Ohio approaches, the states have, after concluding that securities issued in these corporate reorganizations present investor concerns and should be subject to some kind of blue sky law regulation, surrendered their traditional role of reviewing and judging such securities. In the light of the blue sky tradition of state paternalism, the approach taken by the Pennsylvania and proposed Ohio securities acts with respect to these corporate reorganizations is unjustified. If disclosure can replace paternalism here, it should suffice elsewhere in state securities regulation as well.

Disclosure is, of course, not a "bad" solution. It will assure that the security holder's decision can be based on knowledge of the important facts, and it seems to strike a balance between the need for additional investor protection in these reorganizations and the desire for a blue sky procedure that is not too cumbersome. But it must be recognized that what is being given up is agency review of the quality of the security before it can be sold to the public.

V. Conclusion

Blue sky regulation of securities issued through corporate reorganizations should require compliance with the registration provisions of the state securities act and subject these securities to the critical, substantive review characteristic of blue sky paternalism. This additional blue sky protection is necessary in mergers, consolidations, and exchanges of assets for securities because these transactions present many of the same concerns present in a distribution of securi-
ties for cash, concerns which have always been the proper subject of blue sky regulation. At the federal level, the SEC has recognized this worrisome character of reorganization-issued securities: after a long period of exempting these securities from federal registration proved unsatisfactory, it adopted rule 145, which required disclosure equivalent to that exacted for those distributions typically subject to the registration requirements.

But the change in the federal law is not a complete response to the need for investor protection in the reorganization context. Adequate investor protection during these transactions must also be assured at the state level. State paternalism has traditionally sought to guarantee a high degree of investor protection; this protection has not been extended to securities issued in corporate reorganizations. The definitional exclusion and exempt transaction treatments given these reorganization-issued securities in the majority of blue sky jurisdictions ignore the concerns that arise from these transactions. The disclosure approach of the Pennsylvania and proposed Ohio securities acts is a step in the right direction, but falls short of the traditional substantive inquiry of blue sky regulation and the additional investor protection it can afford. Registration and critical administrative review are necessary. Therefore, the states would do well to reappraise their policies and procedures in this area carefully. A change in blue sky regulation of securities issued in corporate reorganizations seems in order.

R. BYRON WALLACE