

RESALE OF RESTRICTED STOCK AND THE SECTION 4 (1 ½) EXEMPTION

by

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Revised December, 2005

Overview

The Securities Act of 1933 does not provide a specific exemption for private resale of restricted securities into the private marketplace.¹ Generally, the activity is not well advised. There is always the specter of being mistaken for an underwriter.

In some cases, lawyers have made the argument that if Section 4(1)² and Section 4(2)³ of the Securities Act of 1933 (the "Act") are read in combination, they provide an exemption recognizable by a court. This so-called Section 4(1 ½) exemption has been allowed by several courts on a case by case basis. Therefore, the 4(1 ½) exemption is a case made exemption not found in the Act, but available to resellers if the facts and the situation fall within the parameters of the courts' various decisions.

Why a Reseller Needs an Exemption

It is not uncommon for investors to wish to re-sell stock which they have acquired through investment in private placements. Investors may wish to realize some gain on the stock prior to a liquidation event or to reduce their risk and exposure to loss. In addition, start-up companies sometimes wish to structure financing through one well qualified and accredited individual who will then resell the stock to persons not qualified or accredited. However, both of these scenarios are dangerous for the reseller, and may subject both the individual investor, as well as, the original issuer to civil and criminal penalties from the authorities. More than likely, if private placement stock is resold without notice to the Company, subsequent investors may have rescission rights against the corporate issuer. Any transfer of restricted stock by an investor may be challenged by the Issuer and the Issuer may refuse to transfer the shares if it has a reasonable basis for believing that the transfer is not rightful. If an Issuer improperly allows a resale to occur, it participates in an illegal distribution, and the corporate officers may find themselves in legal trouble.

¹ Rule 144(a) or 144 (k) allow the resale of stock into the private marketplace if all of the conditions of the Rule have been met so that the reseller will not be deemed an "underwriter" under Section 2(a)(11).

² Under Section 4(1), an investor may resell securities in a non-public exempt transaction if that investor is not an "issuer, underwriter or dealer," as those terms are defined by the Act.

³ Section 4(2) exemption is available only to Issuers. It does not exempt sales by any person who bought their shares from the company and wishes to resell said shares. Section 4(2) requires that there be no immediate distribution by the initial purchasers of a security. Section 4(2) is sometimes called the "Private Placement Exception" or "Issuer Exception."

The sale of securities in the United States is highly regulated by both state and federal law. Under federal law, Section 5(a) of the Securities Act of 1933 makes it unlawful to use the instruments of interstate commerce or of the mails to sell a security unless a registration statement covering the security is in effect. There are a number of exemptions to this registration requirement. However, the black letter rule is: **Any sale of securities which is not exempt must, by definition, be registered with both the federal government and each state into which securities are sold.**

The Basics Concerning Issuance of Securities

The preferred and common stock of a company is called a "security." Membership interests in limited liability companies are also considered securities. The issuance of securities is highly regulated in the United States by the Securities & Exchange Commission (the "SEC"). Companies regularly sell their own securities in order to raise capital. With respect to the sale of securities, the SEC is primarily concerned with the quality of disclosure made by companies to prospective investors. Accordingly, Congress has passed numerous regulations regarding the issuance of securities which require that **all** issuances must be registered unless exempt. Registration of a securities offering is a very time consuming, burdensome and expensive task. Therefore, in most circumstances, it is advantageous to the company to attempt to qualify any prospective offering as exempt from the registration requirements. Most private placements in the United States are offered under the exemption provided in Section 4(2) of the Act (15 U.S.C. Section 77d(2)). This exemption allows for "transactions by an issuer not involving a public offering."

To claim the 4(2) exemption, a company offering securities must satisfy two fundamental requirements. Those requirements are: (1) The issuer may not advertise its offering by a "general solicitation" which is calculated to appeal to the public at large, and (2) the issuer must provide a complete, detailed and accurate disclosure statement to the prospective investor(s) of all material facts and risks associated with the investment in the company. Sometimes, this "disclosure" is called a "private placement memorandum." If the issuer fails to observe these two requirements, the offering will not be deemed to be exempt by the authorities and the issuer may have to return all the money which it received from the investors.

The General Law Regarding Resale under Section 4(2)

Section 4(2) exemption is available only to Issuers. It does not exempt sales by any person who bought their shares from the company and wishes to resell said shares. Historically investors who wished to resell were required to register their securities before reselling unless they could find another transaction exemption.

In order to receive exemption from registration, Section 4(2) requires that there be no immediate distribution by the initial purchasers of a security. If an initial purchaser resells the security, the Section 4(2) exemption may be denied, and the resale(s) are considered part of the Issuer's own original distribution. Unless the entire transaction satisfies the conditions of Section 4(2), the Issuer's offering will be in violation of the registration requirements.

Statutory law does not require that an Issuer undertake any specific procedures to prevent immediate resales. However, Issuers have learned to employ certain standard precautions against premature sales. These precautions include:

- a. Ascertaining the investment intent of the investor/purchaser(s).
- b. Printing restrictive legends on the share certificates.
- c. Issuing stop transfer instructions to transferring agents.
- d. Obtaining investor/purchaser representations in writing stating that they are acquiring the security for their own account and not for resale or a view to distribution.

If an investor/purchaser buys stock in a private placement with the "intent and explicit purpose" of reselling the stock or serving as a conduit from Issuer to other buyers, this violates Section 4(2) of the 1933 Securities Act, and the investor will be deemed to have acted as an underwriter. If this section is violated, the offering may be converted from a private offering into a public offering. Such a conversion would mostly likely be devastating to the Issuer, and require it to register the securities with the SEC and each and every state into which it sold its securities.

The Exception to Prohibition Regarding Resale

Recently, the courts have acknowledged an exception to the prohibition on resales. This exception is called Rule (4)(1-1/2), which is characterized as "a hybrid exemption not specifically provided for in the 1933 Act but clearly within its intended purpose."

In Gilligan Will v. SEC, 267 F.2d 461 (1959), the court held that a person purchasing securities from an issuer is not an underwriter for purposes of Section 4(1) if he resells the securities in transactions that would meet the *SEC v. Ralston Purina* 346 U.S. 119 (1953) requirements concerning Section 4(2) resales ***as long as the purchaser did not originally purchase with a view to distribution.***

To meet the *Ralston Purina* test, the purchasers in the resale must be

- (1) sophisticated, and
- (2) have access to the same information as would be available if the securities were registered.

Accordingly, under the holding in *Ralston Purina*, if an initial purchaser bought securities without original intent to distribute them, but at a later time decides to resell them, he/she/it may do so without destroying the relevant exemption only if the resale buyer is "sophisticated" and provided with the same information as would be available if the securities were registered.

In Securities Act Release No. 1521, the SEC stated that *"It is essential that the issuer of the securities take careful precautions to assure that a public offering does not result through resales of securities purchased in transactions meeting the test set forth in the Ralston Purina case, for, in fact, the purchasers do acquire the securities with a view to distribution, the seller*

(issuer) assumes the risk of possible violation of the registration requirements of the Act and consequent civil and criminal liabilities."

The Ackerberg Court explains the 4 1-1/2 Exemption

The facts in *Ackerberg v. Johnson* are simple. The Chairman of the Board had more shares than he wanted and he resold some to a new investor to make some money. The court ultimately held that there was no public offering because The Chairman had provided to the Buyer sufficient disclosures about the company. Thus, the Chairman was found not to be an "underwriter," and the transaction was entitled to the exception provided in Section 4(1).

In *Ackerberg v. Johnson* 892 F.2d 1328 (1989), the Court confirmed that an underwriter is "one who has purchased stock from the issuer with the intent to resell to the public." (The statutory definition of "underwriter" is found in Section 2(11), 15 U.S.C. Section 77b(11) (1988). The Court further explained that "case law is equally clear that a public offering is defined not in qualitative terms, but in terms of whether the offerees are in need of the protection which the Securities Act affords through registration...Thus the proper focus is on the need of the offerees for information."

The *Ackerberg* Court stated that the applicable and appropriate exemption which allowed the Buyer to purchase shares directly from the Chairman of the Board issuer was Section 4(1).

While the term "Section 4 (1 1/2) exemption" has been used in the secondary literature...the term does not properly refer to an exemption other than Section 4(1). Rather, the term merely expresses the statutory relationship between Section 4(1) and Section 4(2). That is, the definition of an underwriter, found in Section(2)(11), 15 U.S.C. Section 77b(11)(1988), depends on the existence of a distribution, which in turn, is considered the equivalent of a public offering. Section 4(2) contains the exemption for transaction not involving a public offering. Any analysis of whether a party is an underwriter for purposes of Section 4(1) necessarily entails an inquiry into whether the transaction involves a public offering. While the term "Section 4 (1 1/2) exemption" adequately expresses this relationship, it is clear the exemption for private resales of restricted securities is Section 4(1).

Section 4 Exemptions are Not Available to Control Persons

None of the Section 4 exemptions are available to "control persons or affiliates." "Control Persons" are defined as major stockholders of more than 10% of the class of stock, directors, officers, subsidiaries, and persons or entities that control or are controlled by the issuer entity. Such Control Persons are not entitled to resell securities because they are viewed as nothing

more than underwriters, or conduits by which the securities of the corporation pass from the issuer to the public. *U.S. v. Lindo*, 18 F.3d 353 (6th Cir. 1994).

In affirming the rare criminal conviction of a President of a company who pledged corporate securities to a bank, which then foreclosed on those securities after the company defaulted, and resold those securities to the general public, the Court in *U.S. v. Lindo* held that, "Lindo was the "Control Person" behind the sales, and, as an issuer, did not qualify for the Section 4(1) exemption." The Section 4(2) and 4 (1 1/2) exemptions were not available to Lindo either because of the manner of the sale, and because the numerous buyers of stock sold by the bank in this case did not have access to the type of information found in the registration statements.

Suggested Method of Resale

The SEC has suggested that if an Investor seeks to qualify for a Section 4(1-1/2) exception to resell securities that the following methods of sale be applied:

1. Resale purchasers must be solicited directly by the holder of the stock, not by the issuing entity
2. Resale purchasers must be limited in number.
3. Resale purchasers must be provided with full disclosure of the type of information found in registration statements or Private Placement Memorandums.
4. The resale must include the typical characteristics of a private placement, including disclosure of company information and compliance with the purchaser qualification requirements of sophistication and ability to bear risk.
5. The holder must demonstrate that he/she is not making the sale with a view to distribution of securities and not on behalf of the issuer company. This is typically done by having the resale Purchaser make investment representations similar to those originally required by the issuer company.

Exemption from registration under Section 4(2) sometimes called the "Private Placement Exception" or "Issuer Exception" depends on (1) the number of offerees, (2) the sophistication of those offerers, (3) the size and manner of the offering, and (4) the relationship of the offerees to the issuer. *SEC v. Murphy*, 626 F.2d 633, 644-45 (9th Cir. 1980). The offerees' access to financial information about the investment, similar to what would be found in a registration statement is crucial.

Exemptions are construed narrowly and the burden of proof is on the person claiming the exemption. *SEC v. Blazon Corp.*, 609F.2d 960 (9th Cir. 1979), *Sorrell v. SEC*, 679 F.2d 1323 (9th Cir. 1982). Technically the Securities Act does not provide an exemption for private resales of restricted securities. The Section 4 (1 1/2) exemption is not statutory law but a case driven exception. In general, the resale of restricted securities should not be undertaken unless the seller scrupulously observes the suggested methods of resale set forth above. Even then, there is always the risk of being found to be an "underwriter" if the reseller is a "Control Person", or an "Affiliate". When engaged in the sale of securities, it is always best to follow the rules carefully.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.

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