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## GUILD FILMS: A SOLUTION UNDER THE INTRASTATE EXEMPTION

RICHARD D. HAYNES\*

The opinion by the Second Circuit in *Securities and Exchange Commission v. Guild Films Company, Inc.*<sup>1</sup> has not been nominated for an Academy Award by the investment fraternity or bankers, nor has it received rave reviews from legal scholars. Section 5<sup>2</sup> of the Securities Act of 1933<sup>3</sup> requires that if the mails or interstate commerce are used to effect an offer<sup>4</sup> or sale<sup>5</sup> of securities,<sup>6</sup> the securities must either be registered with the Securities and Exchange Commission<sup>7</sup> or the securities or the transaction by which the sale is effected must be exempt from the registration requirements of the Act<sup>8</sup> by a specific exemption under the Act.<sup>9</sup> Violators are subject to both civil<sup>10</sup> and criminal<sup>11</sup> penalties and the Commission is armed with injunctive power to prevent violations of the Act.<sup>12</sup>

Although the Act contains no express exemption,<sup>13</sup> prior to *Guild*

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<sup>1</sup>279 F.2d 485 (2d Cir.), cert. denied sub nom. Santa Monica Bank v. SEC, 364 U.S. 819 (1960).

<sup>2</sup>15 U.S.C. § 77e (1963).

<sup>3</sup>15 U.S.C. §§ 77a-77aa, as amended (1966) (hereinafter referred to as the "Act" and cited by reference to sections of the Act).

<sup>4</sup>The Act defines offer as including "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 15 U.S.C. § 77b(3) (1963).

<sup>5</sup>The Act defines sale as including "every contract of sale or disposition of a security or interest in a security, for value." 15 U.S.C. § 77b(3) (1963).

<sup>6</sup>The Act defines securities as including "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." 15 U.S.C. § 77b(1) (1963).

<sup>7</sup>The Securities and Exchange Commission is referred to hereafter as the "Commission."

<sup>8</sup>15 U.S.C. § 77j (1963).

<sup>9</sup>15 U.S.C. § 77c (1963) lists those securities which are exempt from registration and 15 U.S.C. § 77d (1966) lists those transactions which are exempt from registration.

<sup>10</sup>15 U.S.C. § 77l (1963).

<sup>11</sup>15 U.S.C. § 77x (1963).

<sup>12</sup>15 U.S.C. § 77t (1963).

<sup>13</sup>The Senate originally enacted a clause which exempted from registration sales

*Films* it was generally considered<sup>14</sup> that a bona fide pledge of securities as collateral for a loan did not involve either an offer or a sale and that a foreclosure sale by a bona fide pledgee of securities put up as collateral by the issuer<sup>15</sup> or an affiliate<sup>16</sup> was exempt under § 4(1)<sup>17</sup> of the Act, unless the pledgee himself was in a control relationship<sup>18</sup> with the issuer and also used an underwriter<sup>19</sup> in the disposition of the securities.

The rationale for this opinion was that § 4(1) of the Act exempts from the registration requirements "transactions by any person other than an issuer, underwriter, or dealer."<sup>20</sup> Construed with § 2(11) of the Act, which defines underwriter to include a person who purchases from an issuer with a view to distribution, this exemption had been interpreted to extend to sales by persons who purchase from an issuer for investment.<sup>21</sup> Before *Guild Films*, most legal writers were

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of securities "by or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provisions of the Act, to liquidate a bona fide debt, a security pledged in good faith as collateral for such debt." However, this provision was not included in the final bill passed by Congress. S. REP. NO. 875, 73d Cong., 1st Sess. § 12(b) (1933).

<sup>14</sup>Loss, *SECURITIES REGULATION* 645 (2d ed. 1961), Loss, *SECURITIES REGULATION* 346 (1st ed. 1951) and Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933*, 4 *LAW & CONTEMP. PROB.* 89, 124 (1937); cf. Sargent, *Pledges and Foreclosure Rights under the Securities Act of 1933*, 45 *VA. L. REV.* 885 (1959).

<sup>15</sup>The Act defines issuer as "every person who issues or proposes to issue any security." 15 U.S.C. § 77b(4) (1963).

<sup>16</sup>Rule 405 promulgated by the Securities and Exchange Commission pursuant to the Act defines affiliate as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." 17 C.F.R. § 203.405(a) (1964).

<sup>17</sup>15 U.S.C. § 77d(1) (1966).

<sup>18</sup>The Act states that for the purposes of § 2(11), which defines "underwriter," the term issuer includes also "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." 15 U.S.C. § 77b(11) (1963). Sommer, *Who's "In Control"?*, 21 *BUS. LAW.* 559 (1966).

<sup>19</sup>The Act defines underwriter as, first, a person who has purchased securities from an issuer, or person in control of an issuer, with a view to their distribution; second, a person who offers or sells securities for an issuer or person in control of an issuer, in connection with their distribution; or, third, a person directly or indirectly participating in the underwriting of any such undertaking. 15 U.S.C. § 77b(11) (1963).

<sup>20</sup>The Act defines dealer as "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." 15 U.S.C. § 77b(12) (1963).

<sup>21</sup>Section 4(2) of the Act exempts "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2) (1966). If a person purchasing pursuant

of the opinion that the "purchase for investment" exemption would include foreclosure sales of unregistered securities by a bona fide pledgee.

The decisional support for this theory was meager. The Commission in a case decided in 1939<sup>22</sup> had, at least by implication, indicated that sales by bona fide pledgees were exempt. Much later a court expressed "doubt on the issue of whether or not a sale of collateral by a bona fide pledgee . . . can result in any liability to the pledgor or pledgee."<sup>23</sup> Therefore, *Guild Films* was a case of first impression.

### I. THE GUILD FILMS CASE

*Guild Films* arose when movie-maker Hal Roach was faced by the demand of his bankers that he supply additional collateral for some long overdue personal notes. Roach therefore caused a wholly-owned subsidiary of a corporation in which he was a controlling shareholder to purchase unregistered stock from Guild Films.<sup>24</sup> The stock had been acquired by this corporation pursuant to an investment representation<sup>25</sup> and the share certificates had been legended.<sup>26</sup> How Roach

to the so-called "private placement exemption" at a later date has a valid change of circumstances, then he can sell these shares pursuant to the exemption in Section 4(1) of the Act without registration. *United States v. Abrams*, 357 F.2d 539, 547 (2d Cir. 1966); SEC Securities Act Release No. 4552, Nov. 6, 1962; SEC Securities Act Release No. 603, Dec. 16, 1935; Sargent, *Private Offering Exemption*, 21 Bus. Law. 118, 122 (1965); Orrick, *Some Interpretive Problems Respecting the Registration Requirements under the Securities Act*, 13 BUS. LAW. 369, 375 (1958). Just what constitutes a valid change of circumstances is unclear and recently the Investment Bankers Association has requested that the Commission promulgate specific rules for sale of stock previously purchased subject to the "private placement exemption." *Wall Street Journal*, May 3, 1966, p. 4, cols. 2-3.

<sup>22</sup>*Sweet's Steel Co.*, 4 S.E.C. 589 (1939).

<sup>23</sup>*F. L. Jacobs Co. v. Inland Credit Corp.*, CCH FED. SEC. L. REP. ¶ 90908 (S.D.N.Y. 1959).

<sup>24</sup>Roach was an officer, director and the controlling shareholder of F. L. Jacobs Co. This company controlled Scranton Corp., whose wholly-owned subsidiary, Hal Roach Studios, in turn owned W-R Corp. and Rabco T.V. Productions, Inc. W-R Corp. purchased stock from Guild Films, which covenanted that it would use its best efforts to register the stock. The stock was issued, however, by Guild pursuant to the private offering exemption under § 4(2) of the Act. Interestingly enough, F. L. Jacobs Co. was the plaintiff in the action cited in note 23, *supra*. Alexander L. Guterma was president of F. L. Jacobs Co. and was, contemporary with Roach's Guild Films problems, having securities problems of his own. *United States v. Guterma*, 181 F. Supp. 195 (S.D.N.Y. 1960), 281 F.2d 742 (1960), *cert. denied*, 364 U.S. 871 (1960).

<sup>25</sup>This representation stated that the shares "are being acquired for investment only and not for the purpose or with the intention of distributing or reselling the same to others. Guild is relying on said warranty and representation in the issuance of said stock." 279 F.2d 485, 487 (2d Cir. 1960).

<sup>26</sup>The legend on the face of the certificate read, "The shares represented by

came into possession of this stock is not explained, but he ultimately pledged this stock as further collateral for his personal loans. Upon default the banks attempted to sell the unregistered stock and the Commission sought to enjoin the sale as violative of the registration requirements of § 5 of the Act.

The district court, in granting a preliminary injunction, said:

The Act prohibits purchases with a view to distribution. If the Santa Monica Bank is a bona fide pledgee now seeking to sell collateral it acquired in good faith to secure the debt, it would not appear to come within the statutory prohibition . . . .

The fact that a pledgee as such is not exempt by the Act is not significant, since the activities prescribed by their terms exclude a pledge transaction. The touchstone to the transaction is the good faith of the parties . . . a good faith consisting not of an abuse of intent to evade the statute, but an absence of intent on the part of the one delivering the property that it be sold and an absence of intent on the part of the one receiving it, at the time he receives the property [,] to sell it.<sup>27</sup>

The district court then held that when Roach purchased the additional collateral "he did so in order to have the Santa Monica Bank sell it for his benefit, since he himself could not, and by so doing he became an underwriter under Sec. 2(11) . . . . The Santa Monica Bank, in turn, was no more interested than Roach in acquiring stock which it could not liquidate promptly . . . ." <sup>28</sup> The court thus held that the banks were statutory underwriters. The sale of such collateral by statutory underwriters would have violated the Act and was therefore enjoined.

As Professor Loss notes, "if the last word had remained with the

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this certificate have not been registered under the Securities Act of 1933. The shares have been acquired for investment and may not be sold, transferred, pledged or hypothecated in the absence of an effective registration statement for the shares under the Securities Act of 1933 or an opinion of counsel to the Company that registration is not required under said Act." 279 F.2d 485, 487 (2d Cir. 1960). The agreement containing the investment representation, note 25 *supra*, was dated about two weeks earlier than the stock certificate. The legend on the stock certificate is much broader than the earlier investment representation, which did not specifically refer to a pledge. Although the Second Circuit later found that the banks knew that they had received unregistered stock subject to the restrictive legend, 279 F.2d 485, 490 (1960), of which they certainly had constructive notice, it is possible that through inadvertence or oversight the banks were unaware of the legend.

<sup>27</sup>178 F. Supp. 418, 423 (S.D.N.Y. 1959).

<sup>28</sup>*Id.* at 424.

District Court, or if its judgment had been affirmed on the same reasoning, the case would have served only to confirm the traditional administrative view with respect to pledges as it had been generally understood.”<sup>29</sup> On appeal the Court of Appeals for the Second Circuit completely overruled this traditional view, although it upheld the injunction.

The Second Circuit held first that the bank had purchased with a view to the distribution of the Guild Films stock:

The banks cannot be exempted on the ground that they did not “purchase” within the meaning of § 2(11). The term, although not defined in the Act, should be interpreted in a manner complementary to “sale” which is defined in § 2(3) as meaning “every \* \* \* disposition \* \* \* a security or interest in a security for value \* \* .”<sup>30</sup>

The most critical portion of the Second Circuit’s decision was the utter rejection of the good faith test. The banks argued that they were bona fide pledgees and therefore were “entitled upon default to sell the stock free of restrictions.” The district court had met this defense squarely by holding, in the language quoted above, that the banks were not good faith pledgees as they had acquired the Guild Films stock not as security for the Roach loan but for the sole purpose of selling to effectuate repayment of the loan.

In attacking the good faith test enunciated by the district court, the Second Circuit said:

[T]he statute does not impose such a “good faith” criterion. The exemption in § [4(2)] was intended to permit private sales of unregistered securities to investors who are likely to have, or who are likely to obtain, such information as is ordinarily disclosed in registration statements. . . . The “good faith” of the banks is irrelevant to this purpose. It would be of little solace to purchasers of worthless stock to learn that the sellers had acted “in good faith.” Regardless of good faith, the banks engaged in steps necessary to this public sale, and cannot be exempted.<sup>31</sup>

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<sup>29</sup>LOSS, SECURITIES REGULATION, 647 (2d ed. 1961). Siatron Electronics and Television Corp., Sec. Act Rel. No. 4282 (Oct. 3, 1960).

<sup>30</sup>279 F.2d 485, 489 (2d Cir. 1960).

<sup>31</sup>*Id.* at 490. Apparently, however, the pledgor is not in a position to raise as a defense that a bank by a foreclosure sale might violate the investment requirements of the Act, since the pledgor “is the owner of the stock to be sold and not an investor. Moreover, even assuming a dual involvement by the [pledgor] which could be brought about by his bidding at the auction sale, he would still be an

The result of *Guild Films* has been confusion,<sup>32</sup> but apparently a pledgee by the mere acceptance of a pledge of unregistered securities has made a purchase with a view to distribution.<sup>33</sup> If he then sells the stock, he becomes a statutory underwriter in the distribution of that stock in spite of good faith in taking or selling the stock.<sup>34</sup> In a recent memorandum decision a court has questioned whether a note collateralized with stock is not now illegal in and of itself in view of *Guild Films*.<sup>35</sup>

*Guild Films* has been widely noted.<sup>36</sup> Several writers suggest that subsequent judicial interpretation may restrict the decision. Other writers suggest remedial action, such as the enactment by Congress of a specific exemption,<sup>37</sup> the adoption by the Commission of an inter-

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investor possessed 'of information thought necessary to informed investment decisions.'"<sup>37</sup> *Rogers v. Crown Stove Works*, 236 F. Supp. 572 (N.D. Ill. 1964).

<sup>32</sup>*Fox v. Glickman Corp.*, 253 F. Supp. 1005 (S.D.N.Y. 1966).

<sup>33</sup>The Commission has proposed to amend Rule 16a-6, pursuant to § 16a of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(a) (1966), to provide that a pledge including the hypothecation of a security or the release of a security from a pledge would be deemed such a change in the beneficial ownership of the security pledged as to require corporate insiders to report such a change to the Commission. SEC Securities Exchange Act Release No. 7794, Jan. 20, 1966. If Rule 16a-6 is amended as proposed, the practical effect could well be that, for the purposes of § 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p (1966), a pledge of securities by an insider would be a sale by the pledgor and a purchase by the pledgee. The Commission on December 31, 1964, proposed to amend Form 8-K, a current report required by §§ 13 and 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m & o(d) (1966). This amendment, which has not yet become effective, would require a report to be filed by the company whenever securities of the company have been pledged under such circumstances that a default may result in a change of control of the company. SEC Securities Exchange Act Release No. 7495, Dec. 31, 1964.

<sup>34</sup>Sec. Act Rel. No. 4552 (November 6, 1962); Sec. Act Rel. No. 4282 (October 3, 1960).

<sup>35</sup>*Investment Corporation v. Murray*, CCH FED. SEC. L. REP. ¶ 91309 (S.D.N.Y. 1964). The suggestion raised by this opinion seems to miss the whole point of the *Guild Films* decision, which presumably is applicable only to dispositions of control or unregistered shares and not to dispositions exempt under § 4(1) of the Act as transactions made by any person other than an issuer, underwriter or dealer.

<sup>36</sup>S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS & IN UNDERWRITINGS 79 (Israel ed. 1962); LOSS, SECURITIES REGULATION 645 (2d ed. 1961); Pierce, *SEC v. Guild Films Co., Inc.*, 16 BUS. LAW. 603 (1961); Sargent, *The "Guild Films" Case: The Effect of "Good Faith" in Foreclosure Sales of Unregistered Securities Pledged as Collateral*, 46 VA. L. REV. 1573 (1960); 48 CALIF. L. REV. 841 (1960); 60 COLUM. L. REV. 1179 (1960); [1960] DUKE L.J. 638; 74 HARV. L. REV. 1241 (1961); 36 N.Y.U.L. REV. 901 (1961) 8 U.C.L.A.L. REV. 663 (1961); 13 STAN. L. REV. 652 (1961); 34 TEMP. L.Q. 323 (1961).

<sup>37</sup>Pierce, *SEC v. Guild Films Co., Inc.*, 16 BUS. LAW. 603 (1961). The writer suggests the enactment of the language considered but not accepted by Congress in 1933, as quoted in note 3 *supra*.

pretive rule that a bona fide pledgee does not come within the first and second clauses<sup>38</sup> of the definition of underwriter,<sup>39</sup> or the adoption by the Commission of a rule which would permit bona fide pledgees to issue a "quit claim" offering circular, presumably setting forth the facts of the acquisition, pledge, and default, after which the pledgee could sell the securities at public auction without warranty or representation.<sup>40</sup>

*Guild Films* is, of course, of concern not only to commercial banks but also to finance and insurance companies and all other commercial and non-commercial lenders who take pledges of securities as collateral for their loans. The practical problems with which such pledgees are faced upon default are essentially ones of time and expense. In order to protect themselves, many pledgees now secure from the borrower a covenant that, at the election of the pledgee, the borrower will use his best efforts to obtain registration and will bear the expenses of the registration. However, this may be of little value when upon default the pledgee is left to deal with an hostile and possibly insolvent issuer. Assuming, however, that the issuer is solvent and fully cooperative regarding registration of the pledged shares, under the best possible circumstances today probably a minimum of sixty days will have elapsed between the decision to register and the effective date of the registration statement. In many instances market economics simply will not permit this delay.

Since *Guild Films*, some lenders have begun to use as security for a loan secured by control or unregistered stock a "take out" or "pick up" letter. Typically, a solvent third party will agree with the bank that upon the demand of the lender or upon default by the pledgor the third party will either purchase or will secure a party who will purchase the pledged stock.<sup>41</sup> The third party further agrees that at the time he purchases the stock he will execute an investment letter, which is a letter from the purchaser of the securities representing that he is purchasing the securities for investment and not for the purpose of distribution.<sup>42</sup> This representation forms the basis for a claimed

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<sup>38</sup>See language quoted in note 11 *supra*.

<sup>39</sup>LOSS, *SECURITIES REGULATION* 650 (2d ed. 1961).

<sup>40</sup>S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS & IN UNDERWRITINGS 86 (Israels ed. 1962).

<sup>41</sup>*Cf.* Able Finance Company v. Whitaker, 388 S.W.2d 437 (Tex. Civ. App. 1965).

<sup>42</sup>An investment letter thus contains basically the language of the representation given by Roach to Guild Films quoted in note 25 *supra*. An example of a well drafted investment letter is published in S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS & IN UNDERWRITINGS 27 (Israels ed. 1962). For further comment concerning the use of investment letters, see Sommer, *Who's "In Control"?*, 21 Bus. Law. 559, 585-86 (1966) and SEC Securities Act Release No. 4552, Nov. 6, 1962.



exemption on the part of the lender that under § 4(2) of the Act such disposition of the securities is a private placement not requiring registration. This arrangement assures the lender that there will be a ready and immediate market for the sale of the pledged securities should the pledgor default on his obligations.

The recent decision in *Meadow Brook National Bank v. Levine*<sup>43</sup> illustrates the procedure. After the bank had first demanded additional collateral, the father of the pledgor gave to the bank a "take out" letter agreeing to purchase the notes and pledged securities of his daughter from the bank. The father then defaulted on his agreement. As a defense to the suit of the bank for breach of contract, the father urged that the "take out" letter was void and in violation of the registration requirements of the Act since he "lacked any knowledge or information concerning the status or financial condition [of the issuer of the stock pledged to the bank by his daughter]" and since he had "agreed to acquire the shares not as an investor, but rather, for the purpose of selling them on the open market."<sup>44</sup>

The court refused to strike the defense at this stage of the proceedings and held that triable issues of fact had been raised. The court, however, indicated that if the defendant could prove that "the contract was knowingly entered into in order to circumvent the requirements of the federal legislation and was designed to accomplish that which the legislation specifically had forbidden," as the defendant had alleged, then the "take out" letter would not be enforceable.<sup>45</sup> *Meadow Brook* is silent as to whether the "take out" letter included an investment representation.

Another possible solution for the pledgee is use of Rule 154.<sup>46</sup> The Act defines an underwriter as including a controlling person.<sup>47</sup> Although the Act does not define "control," the term generally includes "either the power to control or the actual exercise of control" of the issuer of the securities.<sup>48</sup> For instance, certainly Roach was in control of the corporation whose wholly owned subsidiary originally acquired the Guild Films stock.<sup>49</sup>

<sup>43</sup>CCH FED. SEC. L. REP. ¶ 91496 (1965).

<sup>44</sup>CCH FED. SEC. L. REP. ¶ 91496, p. 94,870 (1965).

<sup>45</sup>CCH FED. SEC. L. REP. ¶ 91496, p. 94,871 (1965). The outcome of this case is, unfortunately, not yet of record.

<sup>46</sup>17 C.F.R. § 230.154 (1964). Sommer, *Who's "In Control"?*, 21 BUS. LAW. 559, 588 (1966); Hill, *Rule 154 under the Securities Act of 1933 and Related Problems—A Proposed Solution*, 20 BUS. LAW. 335, 340 (1965); S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS & IN UNDERWRITINGS 65 (Israels ed. 1962).

<sup>47</sup>*Supra* note 18.

<sup>48</sup>Sommer, *Who's "In Control"?*, 21 BUS. LAW. 559, 565 (1966).

<sup>49</sup>*Supra* note 24.

A controlling person is not in an enviable position, at least in so far as the saleability of his control stock is concerned. Even if his stock is not investment letter stock and the controlling person has purchased on the open market stock which had previously been registered by the issuer, the mere fact that he is a controlling person means that this stock must be registered before it can be resold. As discussed above, the Act defines the term underwriter as including a person in control of an issuer and a statutory underwriter<sup>50</sup> must for all practical purposes meet the registration requirements of the Act before he makes any distribution.<sup>51</sup>

The Commission has allowed some relief to the control person by promulgating Rule 154. This rule allows an exemption from the registration requirements to a broker who acts as agent for the controlling person in the sale of limited amounts of control securities in a six months' period. The Rule, however, places stringent limitations upon the broker in the sale. For instance, the amount of securities which may be sold under the Rule is limited. With securities sold over-the-counter, no more than one per cent of the securities outstanding may be sold. In the case of securities listed upon a securities exchange, the limit is the lesser of one per cent of the securities outstanding or the largest aggregate reported volume of stock traded during any week of the preceding month.

If it appears that there is a plan to effect a series of sales every six months, the Commission has made it clear that it will consider the transactions as a part of a distribution.<sup>52</sup> Therefore, the Rule, if it is to be utilized, must be used infrequently and with great caution. All sales by the controlling person, whether made pursuant to this Rule or not, are included in the numerical computation.

The Rule was promulgated by the Commission under the provisions of § 4(4) of the Act which exempt from the registration requirements "brokers' transactions, executed upon the customers' orders on any exchange or in the over-the-counter market but not solicitation of such orders."<sup>53</sup> Thus the Commission has stated that this exemption is available only to brokers.<sup>54</sup> The controlling person would generally find his exemption under § 4(1) of the Act which exempts transactions not involving issuers, underwriters or dealers.<sup>55</sup>

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<sup>50</sup>A statutory underwriter is a person defined by § 2(11) of the Act as an underwriter, who may not be an investment banker at all. See note 18 *supra*.

<sup>51</sup>15 U.S.C. § 77d(1) (1966).

<sup>52</sup>SEC Securities Act Release No. 4818, Jan. 21, 1966.

<sup>53</sup>15 U.S.C. § 77d(4) (1966).

<sup>54</sup>SEC Securities Act Release No. 4818, Jan. 21, 1966.

<sup>55</sup>15 U.S.C. § 77d(1) (1966).

A pledgee may find relief under Rule 154, but here again the Commission takes the position that other dispositions of the controlling shareholder during the six months' period must be counted in the calculation of the amount of shares the pledgee can sell under the Rule.<sup>56</sup> Whether the controlling person has abused use of the Rule in the past, or will do so in the future, is of real concern to the pledgee in determining whether to utilize the Rule.

The Commission takes the further position that Rule 154 is not available to a controlling person who holds investment letter stock "if under then existing circumstances public sale of any of the securities would be inconsistent with an intention on the latter's part at the time he acquired the securities to hold them for investment."<sup>57</sup> Thus to utilize the Rule in the case of investment letter stock, the pledgee must at his peril discover whether there has been a valid change of circumstances on the part of the pledgor, a task which is never easy.<sup>58</sup> For all of these reasons, Rule 154 may not be the answer to the pledgee's dilemma.

Controlling shareholders today have the same requirements for financing as do other investors. However, in view of the quandary in which lending institutions currently find themselves as a result of *Guild Films*, it is safe to assert that fewer loans secured with control, investment letter, or other unregistered stock as collateral are being made today. Short of remedial legislation, the promulgation of some sort of rule by the Commission, or further judicial clarification of the situation, what solution is left to the pledgee? In casting about for some resolution to his dilemma, the pledgee might well consider the intrastate exemption.

## II. THE INTRASTATE EXEMPTION

Section 3(a)(11) of the Act exempts from the registration requirements of the Act:

Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State or Territory.<sup>59</sup>

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<sup>56</sup>SEC Securities Act Release No. 4818, Jan. 21, 1966.

<sup>57</sup>*Ibid.*

<sup>58</sup>*Supra* note 21.

<sup>59</sup>15 U.S.C. § 77c(a)(11) (1963).

This exemption was enacted to aid local financing and at first blush appears to be relatively simple; however problems are encountered in nearly every phrase.<sup>60</sup>

The Act provides that a corporate issuer must be both incorporated by and doing business within the state. In a primary offering,<sup>61</sup> it is the Commission's view that the business done must be substantial; however this should not be germane in conjunction with a secondary offering,<sup>62</sup> such as a sale by a pledgee, since the pledgee, if not itself a controlling person, would not have the power to determine whether the issuer's business in that state was substantial. The Commission also takes the position that the requirement that the offerees and purchasers must be persons resident within the state means "domiciled." This has been criticized by Professor Loss, who argues that "the skilled draftsmen of the statute did choose to say 'resident' rather than 'domiciled'."<sup>63</sup>

The Commission has stated that a "basic condition of the exemption is that the entire issue be offered and sold exclusively to residents of the state in question." Consequently an offer or sale outside the state by the pledgee or pledgor or the resale outside the state by one of the purchasers from the pledgee during the period of distribution by the pledgee would, in the view of the Commission, render the exemption unavailable to the entire offering.<sup>64</sup>

The question thus arises as to whether the intrastate exemption would be available to pledgees in what would be a secondary distribution. The Commission has stated that "a secondary offering by a controlling person in the issuer's state of incorporation may be made in reliance on a Section 3(a)(11) exemption provided the exemption would be available to the issuer for a primary offering in that state."<sup>65</sup> Inasmuch as *Guild Films* places the pledgee in the same position as a controlling person, it would seem that this is good authority that a pledgee may also rely on the intrastate exemption.

When the issuer is incorporated and is doing business in Virginia,

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<sup>60</sup>The intrastate exemption has been discussed comprehensively by the Commission. SEC Securities Act Release No. 4434, Dec. 6, 1961.

<sup>61</sup>A primary offering is an offering by the issuer.

<sup>62</sup>A secondary offering is an offering by shareholders rather than by the issuer.

<sup>63</sup>Loss, *SECURITIES REGULATION* 598 (2d ed. 1961).

<sup>64</sup>It is usual for the issuer, underwriter, or dealer, in restricting a primary offering to residents of one state, to require representations from the purchasers that they are bona fide residents of the state and that the purchases are not made for the purpose of resale. Frequently, the share certificates also are legended. *WHEN CORPORATIONS GO PUBLIC* 34 (Israels & Duff ed. 1962).

<sup>65</sup>SEC Securities Act Release No. 4434, Dec. 6, 1961.

would the fact that the pledgee is a resident of or incorporated in New York destroy any reliance upon the exemption? The Commission has said that "it is not essential that the controlling person be a resident of the issuer's state of incorporation," and further "it may be noted that the non-residence of the underwriter or dealer is not pertinent so long as the ultimate distribution is solely to residents of the state."<sup>66</sup> Therefore, the non-residency of the pledgee, who *Guild Films* holds is a statutory underwriter, does not destroy a claim of the exemption, and a pledgee resident in New York could then come into Virginia, make his intrastate sale, and the sale would then be exempt from the registration provisions of the Act.

### III. BLUE SKY PLEDGEE EXEMPTIONS

Once the pledgee has determined that the intrastate exemption under § 3(a)(11) of the Act is available to him, must he then register under the Blue Sky laws of the state where the sale is to be made? As each state has its own securities laws, no blanket answer can be given. However, one of the most universal of all exemptions from the registration provisions under state laws is the pledgee exemption, which exists in forty-five jurisdictions.<sup>67</sup>

<sup>66</sup>*Ibid.*

<sup>67</sup>*Alabama:* Ala. Code tit. 53, § 38(g) (1940); *Alaska:* Alaska Stat. § 45.55.140 (b) (12) (1962); *Arizona:* Ariz. Rev. Stat. Ann. § 44-1844(2) (1956); *Arkansas:* Ark. Acts, § 14(b) (7) (1959); *California:* Cal. Corp. Code § 25151 (1949); *Colorado:* Colo. Rev. Stat. Ann. § 125-1-13(2) (a) (b) (1963); *Florida:* Fla. Stat. Ann. § 517.06 (2) (1957); *Georgia:* Ga. Code Ann. § 22-1833 (1965); *Hawaii:* Hawaii Rev. Laws § 199-5 (g) (1957); *Idaho:* Idaho Code Ann. § 26-1802(b) (1947); *Illinois:* Ill. Laws § 4(E) (1953); *Indiana:* Ind. Laws § 102(b) (7) (1961); *Iowa:* Iowa Code Ann. § 502.5(2) (1962); *Kansas:* Kan. Laws § 17-1262(e) (1959); *Kentucky:* Ky. Rev. Stat. § 292, 410 (7) (1960); *Louisiana:* La. Rev. Stat. § 51:705(2) (1950); *Maryland:* Md. Laws § 26(B) (7) (1962); *Massachusetts:* Mass. Ann. Laws ch. 110A, § 3(c) (1932); *Michigan:* Mich. Laws § 402(b) (7) (1964); *Minnesota:* Minn. Stat. Ann. § 80.06(6) (1961); *Mississippi:* Miss. Code Ann. § 26 (1960); *Missouri:* Mo. Rev. Stat. § 409.050(2) (1959); *Montana:* Mont. Rev. Codes Ann. § 15-2014(6) (1947); *Nebraska:* Neb. Rev. Stat. § 11(7) (Supp. 1965); *Nevada:* Nev. Rev. Stat. § 90.080.6(a) (1965); *New Mexico:* N.M. Stat. Ann. § 48-18-22(G) (1965); *New York:* N.Y. Gen. Bus. Law § 359-f(1) (m); *North Carolina:* N.C. Gen. Stat. § 78-4(2) (1943); *North Dakota:* N.D. Cent. Code § 10-04-06.2 (1951); *Ohio:* Ohio Rev. Code Ann. § 1707.03(E) (Baldwin 1964); *Oklahoma:* Okla. Stat. Ann. tit. 71, § 401(b) (7) (1961); *Pennsylvania:* Pa. Stat. Ann. tit. 70, § 32(4) (1941); *Puerto Rico:* P.R. Laws § 402(b) (7) (1963); *Rhode Island:* R.I. Gen. Laws Ann. § 7-11-8(k) (1956); *South Carolina:* S.C. Code Ann. § 62-52(7) (1962); *South Dakota:* S.D. Code § 55.1904(6) (1939); *Tennessee:* Tenn. Code Ann. § 48-1632(A) (1963); *Texas:* Texas Laws Ch. 269, § 5(B) (1957); *Utah:* Utah Code Ann. § 61-1-14(2) (g) (1953); *Vermont:* Vt. Stat. tit. 9, § 4204(2) (1959); *Virginia:* Va. Code Ann. § 13.1-514(b) (1) (1950); *Washington:* Wash. Rev. Code § 21.20.320(7) (1961); *West Virginia:* W. Va. Code Ann. § 3064 (1961); *Wisconsin:* Wis. Stat. § 189.07(8) (1961); and *Wyoming:* Wyo. Comp. Stat. § 14(B) (7) (1965).

The Uniform Securities Act<sup>68</sup> in § 402(b)(7) exempts from the registration provisions<sup>69</sup> "any transaction executed by a bona fide pledgee without any purpose of evading this act." Nineteen jurisdictions have enacted the language of the Uniform Act verbatim.<sup>70</sup>

Twenty-six other states have the exemption from the registration requirements in some form,<sup>71</sup> several with obvious typographical errors.<sup>72</sup> Of the states which have not adopted the language of the Uniform Act, only Virginia broadly exempts a transaction by a pledgee, as does the Uniform Act. The other twenty-five states exempt a sale by a pledgee. In addition to "sale," California also exempts "offering for sale," while Florida, Idaho, Iowa, Louisiana, Missouri, New York, Texas and Vermont exclude from the exemption "sale," "offering for sale," and "delivery." Where the Uniform Act exempts from the registration provisions "a transaction executed by a bona fide pledgee without any purpose of evading this act," nine states exempt a "sale in good faith";<sup>73</sup> seventeen exempt sales made "in the ordinary

<sup>68</sup>9C U.L.A. §§ 101-419 (1957). The Uniform Securities Act is hereinafter referred to as the "Uniform Act."

<sup>69</sup>9C U.L.A. § 301 (1957).

<sup>70</sup>Alabama, Alaska, Arkansas, Colorado, Hawaii, Indiana, Kansas, Kentucky, Maryland, Michigan, Montana, Nebraska, New Mexico, Oklahoma, Puerto Rico, South Carolina, Utah, Washington and Wyoming.

<sup>71</sup>Arizona, California, Florida, Georgia, Idaho, Illinois, Iowa, Louisiana, Massachusetts, Minnesota, Mississippi, Missouri, Nevada, New York, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Vermont, Virginia, West Virginia and Wisconsin.

<sup>72</sup>The statutes of California, Florida, Iowa, Louisiana, Massachusetts, Minnesota, Missouri, New York, Pennsylvania, South Dakota, Texas and Vermont refer to "security pledged." Where the obvious intent is for the similar Idaho and North Carolina statutes to exempt from the registration requirements the sale by a pledgee of a security pledged in good faith as security for such debt, the statutes of these two states refer instead to a "security pledge." [This word is, however, quoted as "pledged" in the CCH Blue Sky Rep. ¶ 15102 and ¶ 36104, reporting the Idaho and North Carolina statutes.] This changes the entire meaning of the sentence and leads to speculation whether the statutes as enacted exempt only the pledge of the securities by the pledgor and not the subsequent sale of the stock by the pledgee.

Georgia and Tennessee exempt "the sale in good faith and not for the purpose of avoiding the act by a pledge [sic] of securities pledged for a bona fide debt." Here, pledge obviously should read pledgee [*cf.* the statutes of Arizona, Illinois, Mississippi, North Dakota and Ohio which refer to pledgee] and the error makes a substantial difference. This language would indicate that the pledge is a sale and that this is the exempted transaction rather than the subsequent sale of the security by the pledgee. If this be so, the law in these states would now be the same as that announced in *Guild Films*.

<sup>73</sup>Arizona, Georgia, Illinois, Mississippi, North Dakota, Ohio, Tennessee, West Virginia and Wisconsin.

course of business";<sup>74</sup> and thirteen exclude from the exemption sales made to evade the provisions of the Act.<sup>75</sup> In place of the test of "bona fide pledgee" of the Uniform Act, many states extend the exemption from the registration requirements only to securities pledged for a "bona fide debt"<sup>76</sup> or "securities pledged in good faith as security for the debt."<sup>77</sup> Florida, Iowa, Louisiana and Vermont have verbatim the language which was considered but not adopted by Congress,<sup>78</sup> and Idaho, Missouri, New York, North Carolina and Texas have substantially the same language. Rather than exempting a pledge transaction, Nevada simply makes its act inapplicable to such a transaction by excluding "any bona fide pledge" from the definitions of offer and sale. In 1932 the Ninth Circuit<sup>79</sup> held that under the California statute a pledge is a "disposition . . . of [an] interest in a security for value"; hence, a "sale."<sup>80</sup> Contrariwise, the Kentucky Attorney General held in 1965 that an "agreement to pledge stock as collateral for a loan does not constitute a 'sale' or 'transfer' of the stock" without evidence to show an intention on the part of the parties that the pledge operate as a sale so that title to the stock will be transferred without any attempt to liquidate the securities.<sup>81</sup>

The North Dakota statute is noteworthy in two respects. First, it is applicable only if the number of securities sold does not exceed two per cent of the entire issue of each issue of such securities outstanding. Assuming that this means two per cent of the authorized and issued securities of any one class, the limitation places an additional obligation of investigation upon the lender. Second, unless the securities themselves are otherwise exempted by the Act, the pledgee must receive written permission of the Commissioner of Securities before proceeding to sell the pledged securities.

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<sup>74</sup>California, Florida, Idaho, Iowa, Louisiana, Massachusetts, Minnesota, Missouri, New York, North Carolina, Pennsylvania, Rhode Island, South Dakota, Texas, Vermont, West Virginia and Wisconsin.

<sup>75</sup>Arizona, Florida, Georgia, Illinois, Iowa, Louisiana, Mississippi, North Dakota, Ohio, Tennessee, Vermont, West Virginia and Wisconsin.

<sup>76</sup>Arizona, California, Florida, Georgia, Idaho, Illinois, Iowa, Louisiana, Minnesota, Mississippi, Missouri, New York, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Vermont, West Virginia and Wisconsin.

<sup>77</sup>California, Florida, Idaho, Iowa, Louisiana, Massachusetts, Minnesota, Missouri, New York, North Carolina, Pennsylvania, South Dakota, Texas and Vermont.

<sup>78</sup>Quoted in note 3 *supra*.

<sup>79</sup>Cecil B. DeMille Prods., Inc. v. Woolery, 61 F.2d 45 (9th Cir. 1932).

<sup>80</sup>At the time this case was decided, the California statute referred, as do the Idaho and North Carolina statutes today, to a "security pledge." The statute now reads "a security pledged . . ."

<sup>81</sup>Op. Atty. Gen. No. 65-675, CCH Blue Sky Rep. ¶ 70685 (1965).

The Virginia statute is unique in that it is applicable only to isolated transactions<sup>82</sup> which are not effected directly or indirectly for the benefit of the issuer.

#### IV. CONCLUSION

If a pledgee finds himself in a *Guild Films* situation and is able to meet the tests for a valid intrastate exemption under the Act, it seems quite possible that he can then take advantage of a state Blue Sky pledgee exemption in the intrastate disposition of the pledged securities. This appears to be a possible solution, perhaps frequently overlooked, to the dilemma in which many lenders today find themselves.

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<sup>82</sup>Most state acts contain an "isolated sale" or "small offering" exemption. Loss & Cowett, *BLUE SKY LAW* 81-83, 369-74 (1958) discusses and collates the various provisions. The corresponding exemption in the Federal Act is section 4(2), see note 21 *supra*; 70 *HARV. L. REV.* 1438 (1957).





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