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Securities—Section 4(2)—Offer abd Sale of Unregistered Securities Does Not Constitute a Private Offering Where Purchasers Did Not in Fact Possess Adequate Material Information

SECURITIES—SECTION 4(2)—OFFER AND SALE OF UNREGISTERED SECURITIES DOES NOT CONSTITUTE A PRIVATE OFFERING WHERE PURCHASERS DID NOT IN FACT POSSESS ADEQUATE MATERIAL INFORMATION—*Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971).

Defendants Gurn Freeman, Jack Freeman and T. R. Browne comprised all of the officers and shareholders of defendant American International Franchises, Inc. (hereinafter "American"), a Missouri corporation which was formed for the purpose of marketing two national restaurant franchises. Pursuant to the marketing scheme,[1] six franchise sales centers were established during the first year of operation. Due to the personal solicitation of defendant Browne, Florida Franchise Systems, Inc. (hereinafter "Florida Franchise") was formed.[2] Stock in Florida Franchise was offered and sold to plaintiffs by local investors in charge of incorporation. No registration statement had ever been filed as to this stock. Plaintiffs were given exaggerated reports on the success of the other sales centers and false information concerning defendant Browne's business acumen and the required franchise fee.[3] Additionally, plaintiffs were never informed of an SEC investigation of an earlier franchise scheme established by defendants Gurn and Jack Freeman. Plaintiffs subsequently brought suit in federal court under sections 12(1) and 12(2) of the Securities Act of 1933,[4] alleging that defendants' failure to register violated section 5

1. The marketing scheme contemplated a two-step process: (1) American would seek out local investors to incorporate a statewide or regional franchise sales center, and in consideration for the payment of a franchise fee to American, the exclusive right to sell the franchises would be conferred upon the investors; (2) the local investors would then sell stock in the corporation to a small number of persons who would be likely to furnish supplies and services to the restaurants (e.g., an air conditioning company, a builder, etc.). Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 684 (5th Cir. 1971).

2. Browne and one William Osborne advertised in local Florida newspapers, seeking pre-incorporation subscriptions from investors. Three applicants were ultimately chosen to incorporate Florida Franchise and were required to invest $5,000 apiece in the venture. These three local incorporators made all contacts and representations between defendants and plaintiffs, and ultimately sold the stock to plaintiffs. Two of the incorporators joined plaintiffs in the instant action, but were held by the district court to be estopped to recover their investments because they served on the board of directors of Florida Franchise. *Id.* at 685-86.

3. *Id.* at 690. See text accompanying note 53 *infra*.

4. Securities Act of 1933, § 12, 15 U.S.C. § 77*l* (1970), provides:

Any person who—

of the Act,[5] and seeking rescission of the stock sales and the return of their investments. Despite defendants' contention that the offers and sales were exempted by section 4(2)[6] from the registration requirements of section 5, the jury awarded rescission and a return of the stock purchase monies paid, and assessed punitive damages of $60,000 against American, $15,000 against each of the Freemans, and $10,000 against Browne. On appeal, the Fifth Circuit Court of Appeals affirmed the rescission award and reversed the award for punitive damages. *Held*, an offer and sale of unregistered securities to a small group of sophisticated but unrelated purchasers does not constitute an exempt private offering of securities and is open to liability under both sections 12(1) and 12(2) where material information was withheld or misstated so that the purchasers did not in fact possess the requisite information needed to bring their sophisticated knowledge to bear in deciding whether to invest; punitive damages are not appropriate under either section 12(1) or section 12(2).[7]

Section 12(1), which provides a remedy for a violation of section 5, is virtually a strict liability provision.[8] In an action under section 12(1)

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(1) offers or sells a security in violation of [section 5], or
(2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

5. Securities Act of 1933, § 5, 15 U.S.C. § 77e (1970), provides in part:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

. . . .

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

6. Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1970) provides: "The provisions of [section 5] shall not apply to . . . (2) transactions by an issuer not involving any public offering."

7. 448 F.2d at 688-97.

8. *Cf.* Wonneman v. Stratford Securities Co., [1961-1964 Transfer Binder] CCH

a defendant's intent and knowledge are entirely irrelevant considerations.[9] A plaintiff need only allege and prove that (1) no registration statement was in effect as to the securities, (2) a defendant sold or offered to sell such securities, (3) some means of interstate commerce was used in the offer or sale to the particular plaintiff, (4) the action is not barred by the statute of limitations, and (5) an adequate tender was made by the plaintiff.[10]

It seemed clear in *Hill York* that the stock certificates purchased by plaintiffs were securities within the definition of section 2(1) of the 1933 Act.[11] The certificates apparently represented interests in a profit sharing agreement and would thus qualify within the literal bounds of section 2(1). Also, under *SEC v. W.J. Howey Co.*,[12] the certificates would arguably constitute "investment contracts" within the meaning of that section.[13] The court in *Hill York* did not decide this point, however.

A more entwined issue, and one afforded some moment by the court, was whether defendants were sellers within the meaning of section 12. The plaintiffs had never met defendants and did not purchase the stock certificates from them. Rather, the purchases were made directly from the local incorporating investors. Adopting a broad construction of the term seller, however, the court determined that since "but for" the defendants' activities the plaintiffs would not have purchased the stock, the defendants were persons who sold or offered to sell

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FED. SEC. L. REP. ¶ 91,341, at 93,459 (S.D.N.Y. 1961) (good faith belief in counsel's advice that securities were exempt is no defense to liability in action brought under § 12(1)).

9. 3 L. LOSS, SECURITIES REGULATION 1693 (2d ed. 1961) [hereinafter cited as LOSS].

10. *Id. Cf.* Lennerth v. Mendenhall, 234 F. Supp. 59, 63 (N.D. Ohio 1964).

11. 15 U.S.C. § 77b(1) (1970). Section 2(1) defines a security as

> any note, stock, treasury bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a "security" . . . .

12. 328 U.S. 293 (1946).

13. *See id.* at 298-301. In *Howey* the Court carefully scrutinized whether the investor was an active participant in the particular enterprise. Finding that he was not, and that money was invested with the expectation of a return of profits, the Court deemed the financial arrangement to be a security. *See* SEC v. Joiner Corp., 320 U.S. 344 (1943); United States v. Herr, 338 F.2d 607 (7th Cir. 1964). While the plaintiffs in *Hill York* were to provide services in consideration for the stock certificates (*see* note 1 *supra*), they were not expected to actively participate in managing the restaurants. Presumably, this aspect would be handled solely by the local incorporating investors.

within the meaning of section 12.[14] In so doing, the court rejected what it deemed the "strict privity" and "participation" concepts[15] and adopted the criterion employed in *Lennerth v. Mendenhall*[16] for determining when a person is a seller within section 12:

> [T]he line of demarcation must be drawn in terms of cause and effect: To borrow a phrase from the law of negligence, did the injury to the plaintiff flow directly and proximately from the actions of this particular defendant?[17]

Clearly, the defendants were the motivating force behind the Florida Franchise project. They sought out the local incorporating investors, provided training and brochures, and rendered advice. "[T]he defendants did everything but effectuate the actual sale."[18] As such, since the injuries to the plaintiffs flowed proximately from the actions of the defendants, the latter were held to be sellers within the statute.[19]

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14. 448 F.2d at 693.

15. *Id.* at 692. Though the court did not define what it meant by the "strict privity concept," it is evident that it was referring to the well-settled proposition that under sections 12(1) and 12(2) a purchaser may recover only from his immediate seller. 3 Loss at 1719; Folk, *Civil Liabilities Under the Federal Securities Acts: The Barchris Case*, 55 VA. L. REV. 199, 201 (1969). Notwithstanding this strict privity requirement, however, the courts have expanded the term "seller" to include brokers, officers of corporations and advisement services. *Id.* at 202-03. One concept utilized in so expanding the statute is the "participation" theory. Courts espousing this view interpret the statute as compelling defendants to "show that they did not participate in the sale and not merely that they did not actually sell the securities to [the purchaser]." Wonneman v. Stratford Sec. Co., [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,034 (S.D.N.Y. 1961).

The *Hill York* court was certainly justified in abandoning the participation concept. This concept is too broad since it requires defendants to assume the very burden of proof which plaintiffs are saddled with under section 12: showing that defendants are sellers under the statute. *See* Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964); 3 Loss at 1693.

16. 234 F. Supp. 59 (N.D. Ohio 1964).

17. *Id.* at 65; *cf.* Nicewarner v. Bleavins, 244 F. Supp. 261, 266 (D. Colo. 1965):

> It is well established that persons other than the owner of a security may be liable under 12(1). Such persons include brokers or other agents for the seller, and directors, officers, or controlling persons of a corporation. However, in all instances where a non-owner has been held liable, his conduct has amounted to solicitation of the sale. Those decisions simply recognize that a person may sell what he does not own. This imports a causation test into section 12(1): *"But for" the person's conduct, there would have been no sale.* (emphasis added and citations omitted).

18. 448 F.2d at 693. *Cf.* Katz v. Amos Treat & Co., 411 F.2d 1046, 1053 (2d Cir. 1969), wherein the court determined that officer-directors of the defendant corporation, though they had knowledge of the sale of unregistered securities, were not sellers within 12(1) since they did not play an *active* role in facilitating the sale.

19. 448 F.2d at 693. *But cf.* Nicewarner v. Bleavins, 244 F. Supp. 261, 266 (D. Colo. 1965) wherein the court refused to hold an attorney liable as a seller since he

It was conceded by all parties that no registration statement was in effect as to the securities.[20] In defense to section 12 liability, however, the defendants contended that the transactions were exempt from registration pursuant to section 4(2) of the Act—the so-called private offering exemption.[21] It is well-established that the burden of proving the affirmative defense of a private offering is on the defendants.[22] Accordingly, the defendants proffered evidence showing that the Florida Franchise offering was limited to sophisticated businessmen and attorneys planning to do business with the new corporation. Additionally, the defendants asserted that the plaintiffs had access to all information concerning Florida Franchise.[23]

The SEC has long asserted that the determination of whether an offering is public or private is a question of fact which depends upon the circumstances of each case.[24] While the *Hill York* court concurred with this approach, it went further and, in an ominous note of judicial abdication, asserted:

> Although courts accord a marked deference to the expertise of such an agency which is charged with broad regulation of a specific field when reviewing their regulatory action, we do not intimate that their pro-

did not personally solicit the sale, notwithstanding that he had knowledge of plaintiffs' need for protection, drafted all agreements, gave advice, and knew that no registration was contemplated. In contrast, in Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964), relied upon by the *Hill York* court, the defendants had *personally* solicited the sale of securities to plaintiffs. In *Hill York,* the defendants had no personal contact whatsoever with the plaintiffs. Nevertheless, because they were deemed the "motivating force" behind the sale, they were determined to be sellers within the meaning of section 12. 448 F.2d at 693.

The *Hill York* court also found that defendants fell within the scope of section 15 of the Act (15 U.S.C. § 77o (1970) which provides for the vicarious liability under Sections 11 and 12 of certain "control" persons. 448 F.2d at 693-94. Recognizing once again that defendants were the "motivating force" behind the sale of stock, the court held that defendants fell within the definition of section 15 control as set forth in SEC Rule 405, 17 C.F.R. § 230.405(f) (1971):

> The term "control" . . . means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

20. 448 F.2d 686.

21. *Id.* See note 6 *supra.* It was clear that means of interstate commerce were used in connection with the offer to sell or the sale of the securities. 448 F.2d at 693.

22. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953), *citing* Schlemmer v. Buffalo, R. & P. Ry., 205 U.S. 1, 10 (1907); United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir. 1967).

23. 448 F.2d at 690. The court interpreted defendants' assertion that plaintiffs had access "to mean that the plaintiffs could have obtained any information they desired concerning American and the background of the individual defendants if they had just asked." *Id.*

24. SEC Securities Act Release No. 285, at 2 (Jan. 24, 1935).

> cedures are binding precedent. However, to be consistent—which is the constant aim if not the invariable result of the law—and, most vitally, because we find S.E.C. criteria both legally accurate and meaningfully sufficient for testing the issue, we hold that a jury should consider the factors enumerated below which the S.E.C. considers, together with the policies embodied in the Act.[25]

The factors noted by the court include: (1) the number of offerees and their relationship to each other and to the issuer;[26] (2) the number of units offered;[27] (3) the size of the offering;[28] and (4) the manner of the offering.[29] These factors can only be evaluated, however, in light of the statutory purpose of the Act,[30] which is "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[31] Since exempt transactions do not require the protection of the Act, the applicability of section 4(2) depends on "whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.' "[32]

The *Hill York* court correctly recognized that the level of plaintiffs' sophistication is not necessarily determinative in establishing whether

25. 448 F.2d at 687. In light of the rather stringent interpretation of the private offering exemption presented by the SEC in its brief before the Court of Appeals for the Fifth Circuit in SEC v. Continental Tobacco Co., SEC REG. L. REP., No. 127, A-17, A-18 (Nov. 17, 1971) (see text accompanying notes 57-59 *infra*), this statement by the *Hill York* court portends a unified judicial and administrative stance concerning the restricted availability of the private offering.

26. 448 F.2d at 687-88. The SEC and the courts have recently disavowed any safe numerical test in determining whether an offering is public. *E.g.*, SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953); Katz v. Amos Treat & Co., 411 F.2d 1046, 1053-54 (2d Cir. 1969); United States v. Custer Channel Wing Corp., 376 F.2d 675, 679-80 (4th Cir. 1967); *see* 4 Loss at 2644-46 (Supp. 1969).

Additionally, the *Hill York* court noted that relationships between the offerees themselves and the issuer and offerees are significant factors in considering whether a private offering exists. 448 F.2d at 688. *See* Orrick, *Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under the Federal Securities Act*, 21 U. PITT. L. REV. 1, 8 (1959).

27. *See* 448 F.2d at 689, wherein the court noted that the smaller the number of units offered, the greater the likelihood that the offering will be considered private.

28. *Id.*

29. *Id.*

> A private offering is more likely to arise when the offer is made directly to the offerees rather than through the facilities of public distribution such as investment bankers or the securities exchanges. In addition, public advertising is incompatible with the claim of private offering. *Id.* (footnote omitted).

30. SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

31. *Id.* at 124 (footnote omitted).

32. *Id.* at 125.

plaintiffs are able to fend for themselves and are not, therefore, in need of the protection of the Act.[33] The proper criterion is whether the plaintiffs are in such a relationship to the issuer as to have *access* to the same information which a registration statement would disclose.[34] This access must be "meaningful"[35] and its existence often depends upon either the identity of the offerees,[36] or the relationship between them.[37]

In *Hill York*, the plaintiffs were a diverse and unrelated group at the time of the offering. They had neither a position of leverage over the defendants, nor a privileged relationship with them. Nevertheless, the plaintiffs did have access to information concerning Florida Franchise.[38] Arguably, such access was meaningful: "[They] could have obtained any information they desired concerning American and the background of the individual defendants if they had just asked."[39] It was conceded that plaintiffs were sophisticated businessmen and lawyers, and it would appear that had they requested and received relevant information concerning Florida Franchise they would have

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33. 448 F.2d at 690. *See* United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir. 1967): "'[S]ophistication' is not a substitute for 'access to the kind of information which registration would disclose.'" United States v. Hill, 298 F. Supp. 1221, 1228 (D.C. Conn. 1969): "The Supreme Court did not intend in *Ralston Purina* to exempt all offerings to experienced or sophisticated investors. No investor can be said to be sophisticated *per se*. . . ." *But cf.* Bowers v. Columbia Gen. Corp., 336 F. Supp. 609, 624 (D. Del. 1971) (sophistication is relevant in determining plaintiffs' need for protection under the Act); Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963) (the wide business experience of the plaintiffs was a major determination in finding that plaintiffs did not stand in need of the protection of the Act); Repass v. Rees, 174 F. Supp. 898, 904 (D. Colo. 1959) (failure to produce evidence that, *inter alia*, the buyers were experienced investors was determinative in disallowing private offering exemption).

34. SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953): "The employees here were not shown to have access to the kind of information which registration would disclose."

35. *See* Brief, *supra* note 25, at B-6; *cf.* Israels, *Some Commercial Overtones of Private Placements*, 45 VA. L. REV. 851, 860 (1959).

36. *See, e.g.*, Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963) (no public offering where the sophisticated offerees were close acquaintances of the issuer); Value Line Fund, Inc., v. Marcus, CCH FED. SEC. L. REP. ¶ 91,523, at 94,970 (S.D.N.Y. 1965) (sophisticated mutual fund offerees possessed enough leverage at bargaining table to stand without need of protection of the Act).

37. *See, e.g.*, Woodward v. Wright, 266 F.2d 108, 115 (10th Cir. 1959) *and* Campbell v. Degenther, 97 F. Supp. 975 (W.D. Pa. 1951) (close relationship between offerees was relevant in court's finding of no public offering). See text accompanying notes 39-44 *infra*.

38. *See* 448 F.2d at 690.

39. *Id.*

been able to fend for themselves in deciding whether to invest.[40] In *Bowers v. Columbia General Corp.*,[41] decided subsequently to *Hill York,* the court considered whether lack of actual knowledge vitiates the private offering exemption. Determining that it does not, the court noted:

> If offerees have access to the relevant data as a matter of practical business reality, are reasonably equipped to deal with the information available to them, and choose not to take full advantage of their opportunity, I do not think they are within the class which Congress sought to protect by enacting the Securities Act.[42]

In *Hill York,* it was not clear whether the plaintiffs had access "as a matter of practical business reality." However, an affirmative resolution of this query would have been moot in light of the court's enunciation of a new and more stringent private offering standard:

> Obviously *if the plaintiffs did not possess the information requisite for a registration statement,* they could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest. . . . There is abundant evidence to support the conclusion that the *plaintiffs did not in fact possess* the requisite information.[43]

Under this standard, defendants who now rely upon section 4(2) must prove that plaintiff offerees actually possessed information equivalent to that required in a registration statement. Proof of mere access is insufficient, at least in the fifth circuit.

In formulating this standard, the *Hill York* court relied upon the SEC's interpretation of *SEC v. Ralston Purina Co.*[44]:

> The Supreme Court's language does not support the view that the availability of an exemption depends on the sophistication of the offerees or buyers, rather than their possession of, or access to, information regarding the issuer. . . .[45]

40. *See id.;* Bowers v. Columbia Gen. Corp., 336 F. Supp. 609, 624 (D. Del. 1971):

> If sophistication or lack thereof is relevant, the focus must be not so much upon prior experience with the purchase and sale of securities, but rather upon whether the offerees knew what to look for in, and how to interpret, the available information concerning the issuer's business and its profit potential. There are, of course, degrees of sophistication and the men who negotiated the transaction . . . may not be as sophisticated as some other business executives. The term must be given a realistic business construction, however.

41. 336 F. Supp. 609 (D. Del. 1971) (denying preliminary injunction and ruling, *inter alia,* that plaintiffs who had access to corporate information failed to show likelihood of demonstrating inapplicability of private offering exemption).

42. *Id.* at 624.

43. 448 F.2d at 690 (emphasis added).

44. 346 U.S. 119 (1953).

45. Gilligan, Will & Co., SEC Securities & Exchange Act Release No. 5689 (May 7, 1958), *aff'd* Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied,* 361 U.S. 896 (1959).

Though various courts had adopted this "either/or" interpretation of the *Ralston Purina* opinion,[46] no court, prior to *Hill York*, has ever espoused that possession of adequate information is requisite to a private offering. Rather, whether the purchasers had possession of adequate information has been dealt with only as an evidentiary query to determine whether the purchasers had access to adequate information.

It is submitted that neither the language of the *Ralston Purina* opinion nor the purposes of the Act support the strict possession construction afforded by the *Hill York* court. In *Ralston Purina* the employees had no greater access to relevant information than did the public at large. As such, the Court could not distinguish the need of the employees from the need of the public at large and accordingly disallowed the private offering exemption. While possession of adequate information apparently would have vitiated the employees need,[47] the Court refused to extend the standard this far, and instead, enshrined "access to the kind of information which registration would disclose" as the proper test.[48]

The *Hill York* court clearly could have achieved a proper result without extending the private offering standard to "possession." The fact that plaintiffs were a diverse and unrelated group provided one means of disallowing an exemption.[49] An additional means could be found in defendants' failure to proffer evidence concerning the number of offerees, rather than the number of ultimate purchasers. Without such evidence the court would be unable to determine whether the class needed protection, and would be justified in affirming the lower court's decision.[50] Further, the defendants were clearly liable under section 12(2) of the Act.[51] Since the private offering exemp-

46. *E.g., Hill York*, 448 F.2d at 690; United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir. 1967); Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir. 1959); United States v. Hill, 298 F. Supp. 1221, 1228 (D. Conn. 1969); Nicewarner v. Bleavins, 244 F. Supp. 261, 265 (D. Colo. 1965).

47. *But see* 4 Loss at 2632 (Supp. 1969):

> [T]his says too much if it implies that the exemption is assured, no matter what the circumstances, by giving each offeree the same information that would be contained in a registration statement though without the statutory safeguards and sanctions.

48. 346 U.S. at 127; *see id.* at 125-26.

49. *See* notes 35-37 *supra* and accompanying text.

50. 448 F.2d at 691-92; *see* Nicewarner v. Bleavins, 244 F. Supp. 261, 265 (D. Colo. 1965); Repass v. Rees, 174 F. Supp. 898, 904 (D. Colo. 1959); SEC Securities Act Release No. 4552, at 2 (Nov. 6, 1962); 1 Loss at 656.

51. See note 4 *supra*. In determining defendants' liability under section 12(1), the court listed four items of material factual information not made available to the

tion is not applicable to a cause of action founded upon section 12(2),[52] the court need not have discussed the exemption in determining liability under section 12(2).

By positing possession of adequate information as the keynote standard in determining the availability of the section 4(2) exemption, the *Hill York* court took a significant step toward broadening the scope of section 12(1). In determining that the plaintiffs did not possess the requisite information, the court recognized four items of material factual information not made available to the plaintiffs: (1) a brochure which failed to disclose a current SEC investigation; (2) a brochure misrepresenting defendant Browne as an expert in capitalization consulting; (3) a brochure misstating the franchise fee; and (4) a brochure which failed to disclose that the other sales centers were under investigation by various state securities commissions.[53] These same circumstances were the basis for the finding of liability under section 12(2).[54] Section 12(2), however, affords a *scienter* defense:

> [A defendant shall be liable] who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.[55]

Section 12(1) does not offer such a defense, but rather is a strict liability provision for the enforcement of section 5 violations.[56] Since nondisclosure which constitutes a section 12(2) violation is tantamount to non-possession which, under the *Hill York* standard, disallows a section 4(2) exemption, plaintiff-purchasers who are not given the requisite information, and who suspect that defendant-issuers did not know of the nondisclosure, may now choose to file suit under section 12(1). Defendants will thereby be deprived of the scienter defense of section 12(2). Transactions which at one time would have been proscribed only by section 12(2) are now engulfed by the proscription of section 12(1). Under the *Hill York* construction, section 12(2) has been relegated to second-hand status.

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plaintiff (see text accompanying notes 52-55 *infra*). Finding these items to be material (*see* SEC Rule 405, 17 C.F.R. § 230.405(1) (1971)), misleading (*see* 3 Loss at 1701-02), and that defendants did not carry the burden of proving a lack of scienter (*see, e.g.*, Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970), the court held defendants liable also under section 12(2). 448 F.2d at 695.

52. Woodward v. Wright, 266 F.2d 108, 116 (10th Cir. 1959); Moore v. Gorman, 75 F. Supp. 453 (S.D.N.Y. 1948); 3 Loss at 1699.

53. 448 F.2d at 690-91.

54. *See* note 51 *supra*.

55. Securities Act of 1933, § 12(2), 15 U.S.C. § 77*l*(2) (1970). *See* note 4 *supra*.

56. *See* note 8 *supra* and accompanying text.

The *Hill York* court's emphasis on possession reveals an additional and substantially more perplexing problem. While the SEC would agree that in order to comply with section 4(2) a privileged relationship must exist between the offeror and offerees, it would apparently disagree that offerees must be *given* such information as a registration statement would reveal. In its brief on appeal in *SEC v. Continental Tobacco Co.*,[57] the Commission argued that:

> Continental's dissemination of its prospectus tends to demonstrate that its offerees were not knowledgeable or sophisticated and that they lacked meaningful access to corporate information. They had to be "spoon-fed" selected information through promotional brochures, movies, slides and meetings.[58]

Under *Hill York*, offerees must possess the requisite information and, if they do not, it must be given to them. However, according to the SEC's "spoon-feed" doctrine, the very fact that offerees must be given relevant information indicates their lack of sophistication and meaningful access. This obvious contradiction in theory between the SEC and the fifth circuit did not come to a boil in the instant case.[59] But until it does, or until the new federal securities code now being prepared under the auspices of the American Law Institute takes effect,[60] practitioners may be hard-pressed to determine how best to effectuate a private offering exemption for their clients.

Finally, the close relationship which must exist between both the offeror and the offerees and between the offerees themselves in order to satisfy the private offering exemption portends a major conflict between the law relating to the issuance of exempted securities and the

57. 463 F.2d 137 (5th Cir. 1972).

58. SEC REG. L. REP. No. 144, B-1, B-6 (March 22, 1972). *See* Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971).

59. In *Continental*, the fifth circuit chose not to consider the SEC's spoon-feed doctrine in overruling the district court and finding that defendants had failed to establish sufficient evidence of a private offering. 463 F.2d at 161. Nevertheless, there is no cause to believe that the SEC will discontinue espousing this doctrine, and the potential stringencies of the doctrine should be carefully weighed by counsel advising upon the merits of a prospective private placement.

In its brief on appeal in *Continental*, the SEC further asserted that if offerees must rely on an attorney for advice, this *ipso facto* evidences their inability to fend for themselves and thus their need for protection of the Act. SEC REG. L. REP. No. 144, B-1, B-5 (March 22, 1972). Though the court failed to consider this point, it should be noted that the SEC is apparently encouraging prospective investors in complex transactions to forego seeking the advice of an attorney. If so, such advice must be considered ill-founded, since even the most sophisticated mutual funds find it essential to consult counsel on most securities transactions.

60. A.L.I., FEDERAL SECURITIES CODE (Tent. Draft No. 1, April 25, 1972).

recent Rule 144 which now governs the secondary distribution of such securities.[61] Specifically, Rule 144(e)(3)(F) substantially restricts the resale of securities by a group of persons or affiliates who "agree to act in concert." Since investors must necessarily be in close concert at the initial issuance in order to comply with the private offering exemption,[62] it is questionable whether a resale of such restricted securities will be allowed beyond the restraints of 144(e)(3)(F). Until an official interpretation of "agree to act in concert" is propounded, it is suggested that counsel be extremely cautious in affording advice concerning both issuances and secondary distributions.

61. SEC Rule 144, 17 C.F.R. § 230.144 (1972). This Rule prescribes the circumstances under which some holders of some restricted securities may publicly sell those securities without registration. For an excellent analysis of Rule 144, see GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 8.9 *et seq.* (1972).

62. See notes 26, 36 and 37 *supra* and accompanying text.