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Securities Regulation—The Corporate Spin-Off and Registration Under the Securities Act of 1933

With the aid of liberal judicial construction, the Securities Act of 1933¹ has continued to serve the congressional intent of providing “full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof”² In *SEC v. Harwyn Industries Corp.*³ a federal district court held the Securities Act’s registration requirement applicable to the corporate spin-off,⁴ a recently popular scheme for placing unregistered securities on the market and in the hands of the investing public.⁵

The controversy arose as the result of four virtually identical transactions between groups of private individuals and Harwyn Industries, a publicly held corporation. Each exchange involved a separate, wholly owned Harwyn subsidiary which was used as a vehicle to provide a public market for the unregistered shares of a close corporation controlled by the individuals. The typical transaction was initiated by the execution of a contract between Harwyn and the private group. Pursuant

¹15 U.S.C. §§ 77a-aa (1970) (originally enacted as the Securities Act of 1933, ch. 38, §§ 1-26, 48 Stat. 74.

²Securities Act of 1933, ch. 38, 48 Stat. 74 (preamble).

³326 F. Supp. 943 (S.D.N.Y. 1971).

⁴Although difficult to define due to its many variations, the spin-off basically involves the distribution of Corporation *B* stock by Corporation *A* to its shareholders of record. The following examples are typical of the modern spin-off:

Corporation *C* is privately owned but desires a public market for its stock without registration. It makes a non-public offering (§ 4(2) of the Securities Act, 15 U.S.C. § 77d(2) (1970), exempts “nonpublic” offerings from the Act’s coverage) of ten percent of its shares to *D* Corporation, which is publicly owned. Corporation *D* retains a number of *C* Corporation’s shares but distributes most of those received to its shareholders. Soon Corporation *D*’s shareholders will begin to trade Corporation *C*’s shares on the over-the-counter market, and Corporation *C* will thus be rewarded with a public market for its shares without registration.

Corporation *E*, whose shares are publicly held, wholly owns Subsidiary *F*, which is currently void of assets or business activity. Privately owned Corporation *G*, desiring a public market for its shares without registration, transfers its assets to Corporation *F* in return for a controlling interest in Corporation *F*’s stock. Corporation *E* then distributes the remaining shares of Corporation *F* to Corporation *E*’s shareholders. As these individuals trade Corporation *F* shares a market forms. Corporation *G*’s owners now control a public corporation. (This is the exact situation present in *Harwyn*.)

⁵As many as one hundred corporations utilized the spin-off to gain a public market in the years 1967 and 1968. *How Stocks Debut at the Back Door*, BUS. WEEK, March 29, 1969, at 123.

Several motives have been attributed to the recent surge in the number of spin-offs, not the least of which is the expense saved by avoiding registration. For example, it has been estimated

to this contract, the individuals transferred assets, generally those of their close corporation, to the Harwyn subsidiary. In return they received a controlling interest in the revamped subsidiary.⁶ The subsidiary's remaining shares, as further provided by the contract, were then spun off, or distributed in the form of a stock dividend, to Harwyn's approximately six hundred shareholders. Through this spin-off distribution roughly twenty percent of the unregistered shares of the transformed subsidiary, now controlled by the private individuals, was placed on the securities market. Within a short time an over-the-counter market was created for the shares, and those in control became directors of a public corporation. Typically, the price of the spun-off shares increased in value after market entrance but over a period of months declined to what might be termed a "real value," leaving disappointed shareholders with losses.⁷

From its inception this course of conduct was viewed with suspicion by the Securities and Exchange Commission. Even to those perpetrating the scheme, the resulting creation of a public corporation without the delay and expense of registration seemed suspect. These doubts led Harwyn's attorneys to seek advice on the question of registration from Commission counsel in both New York and Washington. When no reply was received, the defendants proceeded with their doubtful activity, initiating spin-offs of the shares of three more subsidiaries. The final Harwyn spin-off came after the Commission's issuance of Securities Act Release

that in a typical \$3,000,000 first offering, registration costs will run at least \$80,000. PRACTICING LAW INSTITUTE, HOW TO GO PUBLIC 95 (1971). Registration is also time-consuming. Preparation of the registration statement sometimes requires months of work by attorneys and accountants. Further, there is a twenty-day waiting period before a submitted statement can become effective, and this period begins to run anew every time the statement is amended. The expedited registration process announced by the Commission in SEC Securities Act Release No. 4934 (Nov. 21, 1968) is rarely granted on a first public offering. PRACTICING LAW INSTITUTE, *supra*, at 156-57. In addition to saving time and money, the avoidance of registration through use of the spin-off provides a means of withholding information from the public concerning the nature of a given corporation. It is the presence of this latter motive which has attracted the attention of the Securities and Exchange Commission.

⁶The court's opinion leads one to conclude that at least two of the Harwyn subsidiaries had ceased business activity prior to the spin-off of their shares. See 326 F. Supp. at 948, 949. As such, they can be termed "shells," legally existing entities without assets or business activity. The "shell game" has long been used as a means of avoiding registration.

⁷326 F. Supp. at 945-51. For example, over-the-counter bid price of the spun-off shares of one corporation ranged from three dollars per share on January 9, 1969, to twenty-two dollars on March 28, 1969, to one dollar on June 30, 1970. *Id.* at 947.

Number 4982,⁸ which denounced certain spin-offs as violative of the Act's registration requirements. In view of continued activity of this nature on the part of Harwyn and other defendants, the Securities and Exchange Commission turned to the courts, claiming a violation of the registration provisions of the Securities Act and seeking injunctive relief.⁹

In upholding the Commission's contention that registration of the shares prior to spin-off was required in each transaction, the court relied on both the broad purposes attributed to the Securities Act and a careful construction of the Act's wording. Noting that the Act's recognized purpose is "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions,"¹⁰ the court determined that this goal was thwarted by the defendants' transactions. In effect, said the court, the result of each transaction was the creation of "a public [*sic*] held company whose shares would be actively traded in the market place without the investing public having the benefit of disclosures that would be required under the 1933 Act [through its registration provision]."¹¹ If the policies of the Securities Act were to be preserved, individuals engaging in conduct such as that perpetrated by Harwyn should be required to register the shares of the transformed subsidiary prior to the spin-off.¹² Further, the court noted that the transactions did not come within the traditional registration exemption long recognized to exist in the case of usual stock dividends.¹³

Having dealt with the purposes of the Securities Act, the court then

⁸SEC Securities Act Release No. 4982 (July 2, 1969) was a policy release on the part of the Securities and Exchange Commission. When it later filed suit against Harwyn and the other defendants, the Commission could not rely on the Release as substantive law but could use the Release as evidence of its interpretation of the law on this question. For the full text of the Release, see H. SOWARDS, *THE FEDERAL SECURITIES ACT, PRIMARY SOURCE MANUAL* 5-76 (1971).

⁹Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (1970), provides that the Commission may bring an action in any federal district court to enjoin conduct constituting a violation of the Act. Section 24 of the Act, 15 U.S.C. § 77x (1970), imposes criminal liability for the Act's willful violation and provides penalties consisting of fines of "not more than \$5,000 or imprisonment not more than five years, or both."

¹⁰326 F. Supp. at 953, *quoting* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

¹¹326 F. Supp. at 952. The information usually required by the Securities Act to be included in the registration statement and prospectus includes "the nature and size of the business, the purpose of the . . . issue of securities, the capitalization of the issuer, its earnings and financial statement, the names of persons who participate in its management and control, and the nature of the securities being registered." E. THOMAS, *FEDERAL SECURITIES ACT HANDBOOK* 9 (1959).

¹²326 F. Supp. at 953-54.

¹³*Id.* at 954. See text accompanying notes 20-21 *infra*.

turned to the wording of the Act itself. The court was forced to wrestle with the question of whether the spin-off of shares to Harwyn's shareholders constituted a sale and therefore fell within the registration requirement.¹⁴ A sale is defined by the Act as "every contract of sale or disposition of a security . . . for value."¹⁵ Initially, the court observed that the Act does not require that the "value" necessary for registration flow from the immediate transferees of the stock. Viewing each transaction in its entirety, it was possible to characterize as "value" the assets transferred to the Harwyn subsidiary by the outside defendants, which in three of the four exchanges provided the contract consideration for Harwyn's spin-off of the shares and the transfer of control to the private individuals. In addition, the court noted the final result of each transaction to be the creation of a public market for the shares of the newly transformed corporation. This, in itself, was felt by the court to be a form of "value" flowing to the defendants.¹⁶ The court therefore found the defendants' activities to violate not only the spirit and purpose of the Securities Act of 1933 but its literal prohibitions as well.¹⁷

The presence of a "sale" is essential to the application of the Securities Act's registration requirement to the spin-off as well as any other transaction. In *Harwyn*, for the first time a federal district court dealt with the question of whether a corporate spin-off constitutes a "sale" within the meaning of the Act. For years this subject has been an enigma

¹⁴The prohibitions forming the crux of the Securities Act of 1933 are found in § five of the original legislation. There it is stated that registration of a security with the Securities and Exchange Commission, through the submission of a registration statement, is a condition precedent to the lawful use of the mails or interstate commerce for the purpose of sale of the security or its delivery after sale. Securities Act of 1933, ch. 38, § 5, 48 Stat. 74, 77, presently codified as 15 U.S.C. § 77e (1970). Thus, literally, if a security is to be traded in a recognized market or over-the-counter, it must be registered with the Commission. Exceptions to § five's broad prohibitions are set forth in the Act, the most important being that they do not apply to "any person other than an insurer, underwriter, or dealer." Securities Act of 1933 § 4(1), 15 U.S.C. § 77d(1) (1970). In *Harwyn* the court summarily dispensed with this exception, classifying Harwyn Industries as an "underwriter within the meaning of § 2(11). 15 U.S.C. § 77b(11)" without further discussion. 326 F. Supp. at 955. Further transactions exempt from the Act are set forth in § four, 15 U.S.C. § 77d (1970). Certain securities are exempted in § three, 15 U.S.C. § 77c (1970).

¹⁵Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3) (1970).

¹⁶As noted by one commentator, the advantages of owning a public corporation include increased liquidity and the status of being a more attractive merger prospect. Comment, *Securities Regulation: Corporate Spin-Offs As A Device For Public Distribution Without Registration*, 42 U. COLO. L. REV. 111, 113 n.13 (1970).

¹⁷326 F. Supp. at 954. Although the court found a violation of the registration provisions of the Securities Act, in view of "equitable considerations" it declined to issue the preliminary injunction against the defendants sought by the Securities and Exchange Commission. *Id.* at 955.

in the area of securities regulation. As earlier noted, a "sale" is defined by the Act to include "every contract of sale or disposition of a security or interest in a security for value."¹⁸ Therefore, according to the terms of the Act, there cannot be a sale without the presence of "value." "Value" has always been broadly defined by courts and commentators. It "includes anything that has value, including a peppercorn. It is much more expansive than just selling stock for cash."¹⁹

In defining a "sale" for the purposes of the Act, the question has long existed as to whether a legitimate analogy can be drawn between the spin-off and the stock dividend. The traditional stock dividend, whereby a corporation distributes dividends in the form of its own securities to its shareholders, has always been considered not to constitute a transaction "for value" within the meaning of the term as used in the Securities Act. This is clear from the legislative history of the Act.²⁰ Since it is not a "sale," the traditional stock dividend has been exempt from the registration requirement of the Act. The result can be explained by the fact that the receipt of a true traditional stock dividend by a shareholder generally does not increase his proportional ownership in the corporation. The Securities and Exchange Commission has also ruled that the distribution of a dividend which the shareholders may elect to take either in stock or cash is not deemed a "sale."²¹

This favored treatment afforded the traditional stock dividend has provided an argument for those advocating the spin-off's exemption from registration under the Securities Act. The major issue of the controversy thus centered on the question of whether "value" was present in the individual spin-off transaction. An affirmative answer would allow the spin-off to be labeled a "sale," bringing it within the ambit of the Securities Act. Unfortunately, there was no prior judicial determination of the question,²² and the Securities and Exchange Commission remained silent for some time.²³

¹⁸Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3) (1970).

¹⁹PRACTICING LAW INSTITUTE, *supra* note 5 at 41.

²⁰In H.R. REP. NO. 152, 73d Cong., 1st Sess. 25 (1933), it was noted: "The House provision . . . exempting stock dividends . . . is omitted from the substitute, since stock dividends are exempt without express provision as they do not constitute a sale, not being given for value."

²¹SEC Securities Act Release No. 929 (July 29, 1936).

²²Note, *The Spin Off: A Sometimes Sale*, 45 N.Y.U.L. REV. 132 (1970).

²³During this period it is clear that the Commission viewed the various spin-off transactions with suspicion. Even though no pronouncement had been made on the subject, it was virtually impossible to get a "no-action letter" from the Commission. See Borden & Ball, *Going Public Through the Back Door*, REV. OF SECURITIES REGS., May 6, 1969, at 123.

In Release Number 4982²⁴ the Commission clearly voiced its opinion that certain spin-offs were within the registration requirements of the Securities Act. Precisely which transactions to be so characterized, however, was not easily discernible from the Release. While only one variation of the spin-off was specifically discussed as being within the reach of the Act,²⁵ the Commission did set forth several conclusions which are valuable in analyzing the spin-off in this context.

Initially, the Release noted the result effected by many recent spin-off transactions—creation of a public market for securities without registration and disclosure. This the Commission branded as contravening the purpose of the Securities Act and resulting in a situation in which “the potential for fraud and deceit is manifest.”²⁶ Secondly, the Release stated that in analyzing a spin-off transaction one must look at the exchange as a whole rather than the distribution to shareholders alone.

As mentioned earlier, the Release was very imprecise in defining the spin-off situations requiring registration. It also contained the confusing remark, “This release does not attempt to deal with any problems attributable to more conventional spin offs, which do not involve a process of purchase of securities by a publicly owned company”²⁷ These limitations greatly reduced the value of the Release. Many unanswered questions and a great deal of confusion were left in its wake.²⁸ Unfortunately, when faced with a pressing and controversial situation, the Commission released a statement of policy both poorly drafted and extremely limited in scope.

In *Harwyn* the court has made a significant step toward clarification of this area of securities law. The court relied little—if at all—on the Commission’s 1969 Release, possibly because of that pronouncement’s limitations. It must be observed, however, that the court in *Harwyn* did affirm the two conclusions reached in the discussion of the spin-off in the Release. First, the court agreed that when a spin-off results in the creation of a public market for the shares of a corporation

²⁴SEC Securities Act Release No. 4982, *supra* note 8.

²⁵The specific example used by the Commission in the Release described the issuance by a nonpublic corporation of a small percentage of its shares to a publicly held corporation which in turn distributed the shares to its shareholders. Issuance of the shares was said to be “sale” as defined by the Act. Further, the activities of the public company were characterized as those of an underwriter, thus bringing the transaction within the registration requirement. *See* note 8 *supra*.

²⁶SEC Securities Act Release No. 4982, *supra* note 8.

²⁷*Id.* The Release does not further define the phrase “more conventional spin off.”

²⁸*See, e.g.* PRACTICING LAW INSTITUTE, GOING PUBLIC: FILING PROBLEMS 126 (1970).

about which very little information is available to the public, the spin-off clearly contravenes the purpose of the Securities Act.²⁹ This frustration of the purpose of the Act and its potentially injurious effect upon investors was an important factor in the decision to subject the spin-off to registration. In view of the many opinions emphasizing the significance of that purpose,³⁰ one can observe that the degree to which disclosure is thwarted by a given spin-off will be given careful consideration by courts in the future.

Secondly, the court affirmed the approach taken in the Release that in analyzing a spin-off one must view the transaction in its entirety, rather than in piecemeal fashion.³¹ It was this frame of reference that proved an important factor in the court's finding that value was present in the *Harwyn* transactions. Viewing each transaction as a whole and observing that "value" need not flow from the initial transferees of the stock, the court held that "value" was present in the form of the assets transferred to the Harwyn subsidiaries by private individuals.³² This is not the first case in which the Commission has made use of a "single-transaction theory."³³ It is, however, the first instance in which it has been applied to the spin-off transaction and may evidence its expanded use in that area.

Harwyn marks the first judicial recognition of "value" in a spin-off situation. In reaching this determination the court cannot be said to have relied on the Commission's Release.³⁴ In the Release "value" was said to flow from a stock issuance by the nonpublic entity to the public corporation. Therefore, the Release seemingly required a transfer of the shares to the public corporation by an unrelated entity prior to the spin-off. This clearly was not the case in *Harwyn*, for there the shares spun off were already owned by the public corporation since they were those of its wholly owned subsidiary. In classifying the assets injected into the subsidiary and the creation of a public market as "value," *Harwyn* set forth independent grounds for finding "value" and hence a "sale" under the Securities Act. To support such a holding the court had to look only

²⁹326 F. Supp. at 953.

³⁰See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 463 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959).

³¹326 F. Supp. at 954.

³²*Id.*

³³See *Great Sweet Grass Oils, Ltd.*, 37 S.E.C. 683 (1957), *aff'd*, 256 F.2d 893 (D.C. Cir. 1958). See also Note, 45 N.Y.U.L. REV., *supra* note 22, at 136.

³⁴SEC Securities Act Release 4982, *supra* note 8.

to logic, statutory construction, public policy, and the frame of reference earlier suggested by the Commission, which called for viewing the transaction in its entirety.³⁵

Harwyn also broke new ground in its reference, through dictum, to a standard never before applied to securities law, the business purpose test. The court observed that no purpose other than to create a public market without registration was advanced by *Harwyn*'s action.³⁶ The use of such a standard has been suggested by one writer as a means of providing an exemption from registration for legitimate spin-offs brought about as a result of true business purposes.³⁷

Harwyn has indeed eliminated a great deal of the confusion which followed the issuance of Release Number 4982.³⁸ It has not, however, categorically established guidelines to determine which of the many spin-off variations are within the scope of the Securities Act's registration requirement. It has, nevertheless, provided the tools for such a formulation. On the basis of *Harwyn*, it is now possible to formulate a rough test to determine which spin-off transactions are subject to registration.³⁹ Does the transaction contravene the purpose of the Securities Act by creating a public market for the shares of a corporation without registration or other means to guarantee ample disclosure? If so, viewing the transaction in its entirety, at the least there would be present the inurement of economic benefit to one or more of the parties in the form

³⁵Commentators have suggested several other theories through which the spin-off transaction could be held subject to the Securities Act's registration requirement. See, e.g. Comment, 42 U. COLO. L. REV., *supra* note 16, at 116-19. However, the approach utilized in *Harwyn* is much more direct than these alternatives and avoids strained analysis by relying only upon construction of the Securities Act.

³⁶326 F. Supp. at 952 n.1.

³⁷Note, 45 N.Y.U.L. REV., *supra* note 22, at 143.

³⁸Action on the part of the Commission following the *Harwyn* decision indicates that it is still relying on Release Number 4982, although its original view as to the applicability of registration to the spin-off has been greatly broadened. In *Prudent Resources Trust*, a Correspondence of the Commission's Division of Corporate Finance handed down only twenty-four days after the *Harwyn* decision, it was held that registration was required when a publicly held real estate investment corporation transferred assets to a wholly owned new corporation and then sought to distribute the corporation's unregistered shares to its shareholders through a spin-off. The Commission's sole support for its decision was a brief reference to Release Number 4982. Strangely enough, the principles set forth in *Harwyn* were ignored although arguably applicable. *Prudent Resources Trust*, Correspondence of the SEC Corporate Finance Division, CCH FED. SEC. L. REP. ¶ 78,138 (April 22, 1971).

³⁹This test assumes, as did the court in *Harwyn*, that the corporation effecting the spin-off can be designated an underwriter within the terms of the Securities Act.

of the creation of a public market. This, as noted in *Harwyn*, satisfies the "value" requirement of the Securities Act and constitutes a "sale." It follows that the spin-off would be subject to the registration requirement of the Securities Act. Application of such a standard would protect the investing public from persons who would conceal information fraudulently, while exempting fully disclosed and legitimately motivated spin-offs from registration.

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