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Continental Republic Corporation v. The Securities Comm. Of Utah : Brief of Appellant

Utah Supreme Court

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In the

Supreme Court of the State of Utah

CONTINENTAL REPUBLIC CORPORATION, a Utah corporation,
Plaintiff and Respondent,

—vs.—

THE SECURITIES COMMISSION OF UTAH,
Defendant and Appellant.

Civil No. 8977

BRIEF OF APPELLANT

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TABLE OF CONTENTS

AUTHORITIES CITED

CASES CITED

STATUTES CITED

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PRELIMINARY STATEMENT

Continental Republic Corporation, the plaintiff below and respondent here, and hereinafter referred to as Continental, brought suit against the Securities Commission of Utah, hereinafter referred to as the Commission, for an order requirng the Commission to register certain securities of Continental. After a pre-trial hearing held on September 4, 1958, the Third Judicial Dis-

trict Court, in and for Salt Lake County, issued a judgment and decree dated September 24, 1958, in which it ordered the Commission to register the securities. The Commission appeals from that order.

STATEMENT OF FACTS

Continental is a Utah corporation capitalized for 1,000,000 shares of Class A common stock of a par value of $1.00 per share, and 2,500,000 shares of Class B common stock of a par value of 1¢ per share. The Articles of Incorporation (R. 9 to 15) provide that each share of Class A and Class B stock shall be entitled to one vote each at any shareholders' meeting. It is further provided that the Class A common stock shall be entitled to 100 times the amount paid in dividends as the Class B stock, and 100 times as much as the Class B stock on dissolution. This does not constitute a preferred right.

Pursuant to Section 61-1-11, U.C.A. 1953, Continental filed an issuer's application with the Commission, seeking to register by qualification 500,000 shares of the Class A common stock to be sold to the public at a price of $1.00 per share. (R. 19-24). By letter dated December 9, 1957, addressed to Continental's attorney (R. 25), the Commission denied the application. That letter is quoted in part as follows:

> It appears that the officers of the corporation have purchased 2,500,000 shares of Class B common at 1¢ per share for which they have paid $25,000. Five hundred [thousand] shares of Class [A] common is to be offered to the public at $1.00

per share. Holders of both classes of stock are to have the one vote for each share; that is, the stockholder of Class A who pays $1.00 for one share will have the same vote as the holder of a share of Class B. stock who has paid 1¢ for his one share. Furthermore, the holders of the Class B. stock are always to control the corporation and also to control the Insurance Company and the Finance Company which you expect to establish with money derived from the proposed public offering.

The promoters put into the corporation $25,000, the public will invest $500,000 and yet will hold a minority of the voting power.

The Commission cannot approve such a proposal and the application referred to is denied. (R. 25).

The Commission made no formal findings of fact, conclusions and order. The above quoted letter constitutes the Commission's rejection of Continental's application.

By letter dated December 20, 1957 (R. 26), Continental proposed to amend its application, and by letter dated December 24, 1957 (R. 28), the Commission rejected the proposed amendment, stating that it did not remedy the objections the Commission previously made. Thereafter, Continental sought and obtained an order from the District Court requiring the Commission to register the securities. The parties hereto stipulated as to essential facts. That stipulation is a part of the record (R. 7 and 8).

STATEMENT OF POINTS

POINT I.

THE SECURITIES COMMISSION OF UTAH ACTED WITHIN ITS DISCRETIONARY POWERS IN DENYING RESPONDENT'S APPLICATION TO REGISTER THE SECURITIES BY QUALIFICATION.

POINT II.

THE PROPOSED SALE OF STOCK BY RESPONDENT WOULD TEND TO WORK A FRAUD ON THE PURCHASING PUBLIC.

ARGUMENT

POINT I.

THE SECURITIES COMMISSION OF UTAH ACTED WITHIN ITS DISCRETIONARY POWERS IN DENYING RESPONDENT'S APPLICATION TO REGISTER THE SECURITIES BY QUALIFICATION.

The primary purpose for creating the Securities Commission of the State of Utah was that of protecting the public in the purchase of securities. There are implied discretionary powers vested in the Commission by virtue of its creation, its powers and duties. It is evident from certain penalties prescribed in the act, that the Legislature considerd the potential harm and injury to the public possible in security sales. It is made a felony to make a statement concerning the sale of securities which is false or willfully exaggerated or would have a tendency to give a less or greater apparent value to securities or property than such actually possesses. See Section 61-1-28, U.C.A. 1953. It is also made a felony for a person to publish an advertisement by or on behalf of any person

who is not registered, Section 61-1-35, or to sell securities which are non-exempt and not registered, Section 61-1-36.

The Utah Securities statute, Chapter 1, of Title 61, enacted in 1925, is primarily a merit statute, as distinguished from disclosure statutes, such as the federal security act; the difference in the two being that in the former the Commission is granted the power to reject the registration if certain conditions and factors are present, and in the latter the securities will be registered regardless of their nature or manner of sale, so long as a full disclosure is made.

As previously indicated, this appeal arose out of the Commission's rejection of Continental's application for registration of securities by qualification under the provisions of Section 61-1-11, U.C.A. 1953. That section provides that all securities not entitled to be registered by notification shall be registered by qualification. It further provides as follows:

> The commssion may require the applicant to submit to the commission the following information respecting the issuer, and such other information as it may in its judgment deem necessary to enable it to ascertain whether such securities shall be registered pursuant to the provisions of this section: * * *

There follow nine paragraphs specifying information to be submitted with the application. The last paragraph of the section provides as follows:

> If upon examination of any application the commission shall find that the sale of security

> referred to therein would not be fraudulent or tend to work a fraud upon the purchaser, and that the enterprise or business of the issuer is not based upon unsound business principles, it shall, upon the payment of the fee provided in this section, record the registration of such security in the register of securities, and thereupon such security so registered may be sold by the issuer, by any registered agent or any registered dealer who has notified the commission of his intention so to do in the manner provided in section 61-1-16, subject, however, to the further order of the commission as hereinafter provided. Such registration shall be valid for a period of one year from the date of entry in the register of securities, unless sooner cancelled, suspended or revoked by the commission for good cause after notice to the issuer of the security.

As the statute above quoted provides, the Commission may reject an application for registration where it would be fraudulent, tend to work a fraud, or is based on unsound business principles. It is submitted that the Commissions' discretionary powers to reject applications are not confined to strict definitions of fraud or unsound business principles as will be discussed hereinafter.

Section 61-1-11, U.C.A. 1953, hereinabove quoted, has not previously been interpreted by this Court on the issue raised here. The Utah Securities law is substantially a copy of the Iowa Securities law, Chapter 502, Code of Iowa, 1958. Many of the sections of the two statutes are identical. In the Iowa Code the counterpart to our Section 61-1-11, and from which the latter was drawn, is

Section 502.7, Code of Iowa, 1958, formerly section 8581-c8. The Iowa statute, Section 502.7, contains the identical language as that quoted above from Section 61-1-11 of our Code, see pages 5 and 6 of this brief.

In a 1939 case, the Iowa Supreme Court interpreted provisions of the Iowa statute comparable to the Utah Securities law. See *Independence Fund of North America vs. Miller* (1939 Iowa), 285 N.W. 629. In that case the Secretary of State (the individual in Iowa occupying the position similar to the Securities Commission in Utah) denied the application of a corporation seeking to register certain declarations of trust and agreements by qualification. That case cannot be compared factually with the instant case, but statements of the court bear strongly upon the interpretation of the Utah statute. The Iowa Supreme Court affirmed the lower court which had upheld the Secretary of State's action. The court made the following statement about the Iowa Securities Act in general:

> An examination of the Statute discloses that it seeks to attain its ends by regulating and licensing the issuer and dealer and inspecting and licensing the security. In scope it differs from the acts of Pennsylvania and certain other states which license the dealer without requiring the qualification of the security and from the Statutes of other jurisdictions some of which require only that the security be qualified and still others which are based solely upon fraud and require no qualification for either dealer or security.

The Utah act, almost identical with the Iowa statute, likewise regulates and licenses the dealer and inspects and licenses the security. The court went on to say:

> * * * Of necessity the legislature was compelled to delegate to the Secretary of State, in his handling of the details of the regulation and enforcement of the act, discretion comparable to the complexities of the situations it was designed to remedy. Otherwise in this and other similar situations such legislation would be rendered practically impotent. * * *

Then toward the end of the decision the following significant statement is made:

> * * * Code Section 8581-c8 [comparable to section 61-1-11 UCA 1953] directs the Secretary of State to find whether or not the sale of the security would be fraudulent or would work or tend to work a fraud upon the purchaser, or that the enterprise or business of the issuer is not based upon unsound business principles. Section 8581-c11 authorizes the Secretary of State to forbid the sale of any security when "in his opinion, the sale thereof would be unfair, unjust or inequitable to the purchaser thereof."
>
> Although the latter provision appears in the section relating to registration of dealers and salesmen, it is plainly indicative of the legislative construction of the former. Under such construction the Secretary of State may refuse the registration of a security if, in his opinion, it is unfair, unjust or inequitable. It is not essential that it be "fraudulent" as this word is ordinarily defined. Since the Secretary of State is thus authorized to use his judgment it is quite proper that stand-

> ards be established upon which to base such opinion and judgment. * * *

This language is particularly significant because the court interprets the statute as giving the Secretary of State discretionary powers to reject applications to register securities when they are unfair, unjust and inequitable. It is conceded that there are some differences in the Utah and Iowa security laws and that in some respects the Iowa Legislature has granted what appears to be broader powers. However, the statutes are identical in substance; the Utah statute was patterned after that of Iowa, they are both enactments for the purpose of protecting the public in the matter of security purposes, and they are essentially merit statutes. What is most significant is that the Iowa Court, in construing the same section of their act as this court is called upon to analyze now, Section 61-1-11, went beyond the language of the section and found implied powers in the Secretary of State to reject the application where it was unfair, inequitable and unjust.

The securities scheme proposed by the plaintiff's application is, on its face, unfair and inequitable. The potential harm to the buying public in such scheme is apparent on an analysis of plaintiff's application and articles of incorporation. Two promoters purchased all of the Class B stock (the 1¢ stock), 1,250,000 shares each. Their outlay, therefore, of $25,000.00 ($12,500.00 each) will enable them to excercise complete control over the policy, operations and management of the corporation.

The public, who is asked to invest $500,000.00 in the corporation, therefore, contributes, as compared to the two promoters, 95 percent of the corporate capital, and obtains only 20 percent of the voting power. This approaches a subterfuge. Why are the holders of Class A stock given any vote; they acquire no effective voting power thereby. It is a sham which induces the public to believe they are buying securities possessing voting rights.

It has been argued that this is similar to the issuance of preferred stock and that such is a common practice in corporate security issues. But this is not preferred stock; no preference right is granted, nor does the Class A stock possess cumulative rights. The provision in the Articles of Incorporation that holders of Class A stock are entitled to 100 times the amount of dividends paid on Class B stock and 100 times the amount paid on distribution is not effective protection. There is no guarantee that dividends will ever be paid. It is noted that the two promoters who purchased all of the Class B stock are also officers of the corporation. It is not uncommon in small corporations that dividends are never paid because officers' salaries and administrative expenses consume all profits. Another potential harm is that the promoters-officers could call a meeting of stockholders, amend the Articles of Incorporation, and make an assessment of all shares of Class A stock.

POINT II.

THE PROPOSED SALE OF STOCK BY RESPONDENT WOULD TEND TO WORK A FRAUD ON THE PURCHASING PUBLIC.

Section 61-1-11, U.C.A. 1953, hereinabove discussed, and quoted in part, includes the provision that the Commission may not register securities if the sale of such would "tend to work a fraud on the purchaser". That phrase "tend to work a fraud" is not commonly defined in the texts or the decisions. Obviously it was intended to have some meaning or it would not have been included; and it must have a meaning different from "fraudulent" or the two terms would not both have been included. The term "tend" has the following synonyms and definitions: "Stretch", "relate to", "to be directed to or have a tendency, conscious or unconscious, to any end, object or purpose." Webster's New International Dictionary, 2nd Edition. By reason, the phrase means something less than "fraudulent"; the use of the term "tends" compels that conclusion. The essence of fraud is misrepresentation. This phrase therefore might be said to mean tends to misrepresent.

It is submitted that the proposed scheme goes beyond the point of unfairness and "tends to work a fraud on the purchaser." in the following particulars: First, the Class A stock is advertised and sold as possessing a voting right, when as a practical matter 83% of the voting stock is held by two of the promoters. The voting right acquired therefore by Class A stockholders is meaningless. Second, the public is also informed that the Class A stock is

guaranteed to receive 100 times the amount of dividends and 100 times the amount paid on distribution as the Class B stock. However, as previously stated, the stock has no preferred or cumulative right, and more significantly there is no assurance that any dividend will ever be paid.

CONCLUSION

It is respectfully submitted that the judgment of the lower court should be reversed.

Respectfully submitted

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