1970

Stanley Skiba v. Homestead Minerals Corporation Formerly Homestead Oil Corporation : Brief of Appellant

IN THE

SUPREME COURT

OF THE

STATE OF UTAH

STANLEY SKIBA,

Plaintiff and Respondent,

vs.

HOMESTEAD MINERALS CORPORATION formerly HOMESTEAD OIL CORPORATION, a corporation,

Defendant and Appellant.

BRIEF OF APPELLANT

Appeal from a judgment against
granted by the Third District
Salt Lake County, State of Utah
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TABLE OF CONTENTS

AUTHORITIES CITED

Cases:

STATUTES OR REGULATIONS

BOOKS OR ARTICLES

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STANLEY SKIBA,

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vs.

HOMESTEAD MINERALS CORPORA-
OIL CORPORATION, a corpora-
OIL CORPORATION, A corpora-
tion,

Defendant and Appellant.

Case No. 11677

STATEMENT OF THE NATURE OF THE CASE

Respondent seeks to require Appellant to transfer for a sale some 10,000 shares of its common stock which Respondent acquired in a "private placement" transaction under an investment letter.

DISPOSITION OF THE LOWER COURT

The case was heard May 1, 1969, by the Honorable Bryant H. Croft, on an Order to Show Cause served on Appellant. Briefs were thereafter filed and on May 7, 1969, the Court signed its Findings, Conclusions and Decree re-

quiring Appellant to transfer Respondent's stock and permit sale thereof.

RELIEF SOUGHT ON APPEAL

Appellant seeks reversal of the lower court decree, claiming that it would be unlawful under Federal Securities law to require free transfer of "investment" stock.

STATEMENT OF FACTS

On February 29, 1968, Respondent conveyed to Appellant an interest in certain mining claims in Nevada for which Respondent was issued 10,000 shares of Appellant's nonassessable common stock under Certificate No. 4982. The certificate was not issued until April 16, 1968, but was pursuant to the earlier transaction. The certificate bears an investment legend stating:

> "Investment stock not subject to transfer until the 29th day of March, 1969."

The stock was issued by Appellant without any securities registration in accordance with the exemption from registration popularly known as the "private placement" exemption under the provisions of Section 4(2) of the Securities Act of 1933, as amended. (R. 25)

On July 9, 1968, Respondent Skiba was issued 1,111 shares of the nonassessable common stock of Appellant represented by Certificate No. 6493, again in exchange for certain mining interests. That stock was also issued under the "private placement" exemption but the certificate bears a different form of investment legend stating:

> "Investment stock not subject to transfer until registered under the Securities Act of 1933 or a prior opinion of counsel, satisfactory to the issuer, that registration is not required under the Act." (R. 22 and 24)

After March 29, 1969, Respondent presented Certificate No. 4982 for 10,000 shares to the transfer agent of Appellant and requested an issue of new certificates for 10,000 shares of stock without any investment legend. Appellant refused to effect the requested transfer. (R. 26) This action was subsequently brought to compel such transfer free of restriction so that Respondent could sell all or part of the 10,000 shares made the subject of this action.

ARGUMENT

POINT I

THE INVESTMENT PERIOD REQUIRED BY LAW HAS NOT EXPIRED AND THE PARTIES WOULD BE IN VIOLATION OF FEDERAL LAW IN SELLING OR TRANSFERRING UNREGISTERED STOCK.

In approaching the question of what constitutes a sufficient "holding period" to permit lawful sale of investment stock acquired in a private placement transaction, Appellant is admittedly in a rather embarrassing position in this particular case. The stock certificate involved in this action bears an investment legend indicating:

> "Investment stock not subject to transfer until the 29th day of March, 1969."

Notwithstanding the specified date on the stock certifi-

cate, Appellant claims that it is not permitted by law to effect a transfer of the stock free of the investment restriction. The only answer to this incongruity is that the investment legend placed on the stock in that particular transaction was placed there by former management of Appellant without benefit of counsel. Respondent claims, of course, that he had a contract with Appellant permitting transfer of the investment shares following March 29, 1969. However logical that argument may appear, however, it should even more clearly appear from the law cited herein that investment stock acquired in a private placement transaction cannot be freely transferred upon the expiration of any particular holding period unless clearance is obtained from the Securities and Exchange Commission. The erroneous assumption of law engaged in by prior management of Appellant will not constitute a ground for evading the law as Respondent is now requesting.

It is well known to this Court that the purpose of a private placement transaction is to issue stock in a transaction not involving members of the public. Presumably, the person receiving the stock without a full registration with the Securities and Exchange Commission is sufficiently knowledgeable to fend for himself in acquiring information regarding the issuing corporation. The public at large is entitled to the protection of the information required in a registration statement and prospectus. Nevertheless, certain investment stock can be sold under rules and guidelines that are loosely stated in SEC practice. The matter of a "holding period" for investment stock, as evidence that the stock was taken for investment and not for public distribution, is somewhat elusive. The most intelligent discussion of the

problems surrounding investment stock are contained in a recent document known as "The Wheat Report," constituting a detailed study by the SEC staff, chairmaned by Francis M. Wheat, one of the SEC commissioners. The report is more properly entitled "Disclosure to Investors, a reappraisal of federal administrative policies under the '33 and '34 Acts." The report is widely distributed through the auspices of Commerce Clearing House, Inc., and a copy of the complete report is found in the Utah State Law Library. Believing this to be a valid source of authority establishing current SEC practice and affiliated law, quotations from the report will be most helpful. The Wheat study describes the present problem as follows:

> "2. *Problems associated with present doctrine and their consequences.*
>
> (a) *'How long do I have to hold?'*
>
> The Commission has indicated that 'one evidentiary fact' to be considered in determining whether or not a private purchaser took with the necessary investment intent is the length of time between acquisition of the securities and resale.[13]
>
> Will any particular holding period furnish sufficient evidence of investment intent? No definite answer is available. In the language of the Commission's statement, the weight to be given to the holding period will vary with the circumstances of each case. Of course, the longer the period of retention, the more persuasive would be the argument

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[13]Securities Act Release No. 3825

that the resale is not at variance with original "investment intent" . . .[14]

Other pronouncements on this subject by the Commission and its staff furnish little additional clarification.[15] In its opinion in the *Crowell-Collier* case,[16] the Commission observed that '. . . holding for one year does not afford a statutory basis for an exemption . . .' Subsequent to *Crowell-Collier*, former Chairman (then Commissioner) Cohen remarked that a presumption of investment intent might arise after a two-year holding, a statement which has sometimes been referred to as the 'Cohen two-year rule.' Its author clearly indicated, however, that certain kinds of factual situations would negate any such presumption, despite the period of holding.[17] A very recent comment on the subject by an experienced private practitioner is as follows:

> . . . As a practical matter, the shares may . . . be sold in any manner after the lapse of a sufficient amount of time, the period being rather indefinite but probably two to three years. For the record, however, it is official dogma that if stock is acquired for investment, a lapse of time (no matter how long) does not automatically free the stock from restrictions on resale. (Footnote omitted)[18]

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[14]Id.

[15]Omitted

[16]*Crowell-Collier Publishing Co.* Securities Act Release No. 3825, p. 7 (August 12, 1957).

[17]*SEC Problems of Controlling Stockholders and in Underwritings*, 30-31 (Israels, ed., 1962).

[18]Schneider, *Acquisitions Under the Federal Securities Laws—A Program for Reform*, 116 U. Pa. L. Rev. 1323, 1337 (1968).

> Members of the Commission's staff have on occasion advised investors who hold privately placed debt securities that the staff would not look with disfavor on a resale after five years." (The Wheat Report, 164, 165)

The stock of Respondent made the subject of this action was issued in April 1968 but was effective as of the transaction date, February 29, 1968. In even the most liberal of the SEC interpretations cited above, a holding period of at least *two years* must exist as one of the factors the SEC will consider in whether or not investment stock may be sold to the public without registration. Since Respondent here is attempting to sell his stock without restriction (R. 12), he may create various civil and criminal liabilities of the Securities Act of 1933 unless all of the legal factors exist which are required by the SEC. It has been conceded by Appellant that the legend placed on Respondent's stock under instructions of previous management may have been deficient in form. It is here submitted, however, that Appellant should not be required to participate in an illegal action merely to correct the deficiency in form or to permit a public sale of unregistered stock. The courts should refuse to enforce a contract where such enforcement would create an illegal result. *Haddock vs. Salt Lake City* (1901) 23 Utah 521, 65 Pac. 491 and *Neil vs. Utah Wholesale Grocery* (1922) 61 Utah 22, 210 Pac. 201.

Respondent has not satisfactorily rebutted the presumption that the securities were acquired by him from Appellant for investment and that the requested transfer may be made without creating a violation of the federal registration requirements. It has been repeatedly held that

the party seeking to establish that securities have been acquired under the provision of an exemption from the registration requirements of Section 5 of the Securities Act of 1933 (called the "Act" in this brief) rests with the party claiming exemption. *U. S. vs. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir. 1967). (See CCH Federal Securities Law Reporter, Volume 1, Paragraph 2850.126 for additional citations.) If, as a matter of fact, Respondent acquired the securities with a view to distribution, he would be considered an "underwriter" under the provisions of Section 2(11) of the Act. The issue of securities to Respondent by Appellant would constitute a distribution of securities by an issuer through an underwriter, which by definition could not be done lawfully under the provisions of Section 4(2). Any further sale by Respondent as an underwriter would certainly be unlawful.

Respondent alleges in Paragraph 3 of the complaint (R. 1) that a sufficient amount of time has elapsed since the acquisition of securities in question by him to rebut any presumption that such were acquired for investment and that, therefore, the certificates may now be transferred and the acquired securities disposed of. Such allegation does not conform with law, and the lower court's finding that Appellant's defenses are "without merit" (R. 26) is most untenable.

In 1957, the Commission issued an additional interpretation of the exemption upon which the Respondent relies, which stated in pertinent part as follows:

> "Holding for the six month capital gains period of the tax statute, holding in an 'investment account'

> rather than a 'trading account,' holding for a deferred sale, holding for a market rise, holding for sale if the market does not rise, or holding for a year does not afford a statutory basis for an exemption and, therefore, does not provide an adequate basis on which counsel may give opinions or businessmen rely in selling securities without registration. Purchasing for the purpose of future sales is nonetheless purchasing for sale and, if the transaction involves any public offering even at some future date, the registration provisions apply unless at the time of the public offering an exemption is available." Securities Act Release No. 33-3825.

Since Respondent has not held the securities involved for a period of at least two years prior to an attempted disposition thereof, it is respectfully submitted that neither the Appellant nor the court can conclude that the presumption that the securities were acquired for distribution has been satisfactorily rebutted and, therefore, the requested relief should have been denied by the lower court.

Assuming the stock in question is transferred and sold, who would stand to lose? If the exemption cannot be supported and is not available, Respondent violates Section 5 of the Act by selling unregistered stock, so that the transaction is subject to rescission or Respondent is liable for damages. The liability would also attach to the broker who is the agent of Respondent and may encompass the broker's salesmen, even though they are unaware the stock was not exempt. More seriously, from our point of view, there is authority to the effect that the liability would attach to Appellant as the issuer. See *S.E.C. vs. Mono-Kearsarge Consolidated Mining Company,* 167 F. Supp. 248, (U. S. D. C., Utah, 1958). Although that case involves the issuance

of an injunction against sales and transfers of unregistered stock, and civil liability was not immediately involved, much of the Court's language could be used to support civil liability on the basis that the corporation in fact contemplated or acquiesced in a subsequent public redistribution of unregistered stock.

POINT II

THE RECORD DOES NOT SHOW RESPONDENT'S "CHANGE IN CIRCUMSTANCES" NECESSARY TO CLAIM ANY EXEMPTION FROM REGISTRATION.

In Paragraph 3 of the complaint, Respondent alleges:

> ". . . plaintiff has sustained a change in his investment intent which now permits him to sell said shares of stock . . ." (R. 1)

Such allegation can refer to no factor other than a "change in circumstances," which is one of the factors considered by the courts in determining the validity of stock sales under an exemption from registration.

The question then arises, is an immediate sale permissible because of a sufficient change in Respondent's circumstances as would, in effect, not negate the original representation that the acquisition had been for investment purposes? It seems that Respondent's complaint is predicated entirely upon this theory. The Wheat Report describes the problem as follows:

> "(b) What is a sufficient 'change of circumstances?'

As noted above, the 'change of circumstances' doctrine resulted from the felt need for an affirmative demonstration of an original investment intent. If an investor suffers a 'change of circumstances' between his original purchase and his subsequent resale, one can argue on the basis of factual evidence that resale was not contemplated from the very start. But what is a sufficient 'change of circumstances' for this purpose?

This has always been a troublesome question.

In the first place, a change that could reasonably have been anticipated at the time of purchase will be of no evidentiary value."

* * *

Secondly, it has been held that no change of circumstances occurs where investors anticipate business success only to be disappointed by actual results.[20] There is an analogous proposition: neither an advance nor a decline in the market value of the securities purchased can constitute a valid 'change of circumstances.'[21]

Thirdly, the substantiality of the required 'change of circumstances' varies directly with the length of time between purchase and sale. The shorter the time, the more drastic the required change. Is there a minimum period, in all events? This is unclear, and

. . . prudent counsel would prefer to see the

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[20]*Gilligan, Will & Co. v. SEC*, 267 F. 2d 461, 468 (2d Cir., 1959) *cert. den.* 361 U.S. 896.

[21]Crowell Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957).

> passage of at least two years as partial basis for his opinion that sale may be made because of a change of circumstances which was not contemplated at the time the security was originally acquired."[22]

In most of the reported cases, the changes in circumstances were considered to be an *insufficient* basis for the claim of exemption. (See Cohen, Federal Legislation Affecting the Public Offering of Securities, 28 Geo. Wash. L. Rev. 119, 142, 1959). The change of circumstances theory is obviously somewhat elusive also. We submit, therefore, that Respondent's complaint fails to establish a statutory basis for an exemption under an alleged change of circumstances.

Of more importance to the present determination, however, is the complete absence of any evidence in the record sustaining Respondent's claim of a change in circumstances, nor has Respondent asked for a hearing to present such evidence. The lower court was disposed to rule for Respondent as a matter of law, but certainly such ruling was premature and improper without any evidence in the record against which Respondent's claims could be tested.

Moreover, Respondent has not exhausted all other possible remedies in that there is no evidence he has made any request to the SEC for a "no-action" letter which would protect Respondent and Appellant from any injunctive or similar action being instituted by the Commission, if the requested transfer is made. Such a letter might be obtained

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[22]When Corporations Go Public, 20, (Israels and Duff, Jr., eds., 1962).

from the Commission upon a proper showing of change in Respondent's circumstances. (The Wheat Report, p. 156.)

POINT III

RESPONDENT IS ESTOPPED FROM SELLING THE SUBJECT STOCK IN APPELLANT CORPORATION BECAUSE OF HIS OWNERSHIP OF OTHER INVESTMENT STOCK AND THE APPLICATION OF THE SEC'S "FUNGIBILITY" NOTION

The record evidences that Respondent's 10,000 shares of Homestead Minerals Corporation Common Stock was acquired prior to April 16, 1968, as part of an issue under contract effective February 29, 1968. (R. 25, 26) Subsequently, and on July 9, 1968, Respondent obtained an additional 1,111 shares of investment stock bearing the legend:

> "Investment stock not subject to transfer until registered under the Securities Act of 1933 or a prior opinion of counsel, satisfactory to the issuer, that registration is not required under the Act."

Respondent's acquisition of such stock under the more rigorous investment representation falls squarely within the rule that *all* stock is deemed to be held for investment if part of it is held under investment restrictions, irrespective of the manner and time of purchase of any of the stock.

The SEC counsel and staff have promulgated and are enforcing a theory to the effect that if a person holds investment stock from a corporation, all stock of the same issuer held by him, whether obtained in the market or otherwise, is "tainted" by the investment intent. He is thus prohibited

from selling any of his stock of that corporation until it is registered or otherwise made exempt from registration. Sometimes called the "fungibility notion," the theory has not yet been enshrined in any statute, regulation, or judicial decision. It is effectively described in a very interesting article: Kennedy—"The Case of the Scarlet Letter or the Easy Way Out 'Private Offering' " The Business Lawyer, Vol. 23, No. 1, November, 1967.

More authoritatively, the Wheat Report states:

> "(d) *The peculiar effects of the 'fungibility concept.'*
>
> If there is to be an 'investment intent' test for exemption under the '33 Act, the fungibility of securities purchased at different times is essential to its integrity. An example will illustrate the concept:
>
> > A purchases 10,000 shares of the common stock of a particular issuer in the trading market. One year later he acquires 10,000 additional shares directly from the same issuer in a non-public transaction. Ten days after the latter transaction, without having experienced any 'change of circumstances,' A seeks a 'no-action' letter from the Commission's staff regarding the proposed sale to the public of the 10,000 shares he purchased in the trading market. The 'no-action' request would be denied. All of the shares now held by A would be deemed to be restricted against public sale."
>
> * * *
>
> " 'Fungibility' also applies, of course, when successive blocks of the same security are purchased in

a series of private offerings. A special application of the fungibility doctrine relates to so-called 'contingent stock' issued in acquisitions. Assume that company A acquires company B from its 7 shareholders, agreeing to issue 50,000 shares of A's common stock in exchange for the stock of B, and also agreeing that if B's business maintains or achieves certain levels of profitability (and not otherwise) the 7 shareholders of B will be entitled, five years later, to an additional 25,000 shares of A. C, one of the 7 shareholders of B, receives 2,000 shares as his portion of the 'contingent' block of 25,000 shares. A month later he decides to sell a portion of the shares acquired by him five years previously. The Commission's staff, in denying no action requests under similar circumstances, takes the position that the receipt of the 'contingent' shares starts a new holding period as to all shares of the same class then held by C.

In application, the present 'fungibility concept' bears little relationship to the needs of investors for disclosure. It has never been formalized as a Commission rule or interpretative release, and hence introduces an additional element of uncertainty into an already clouded situation. It is essential, however, to prevent evasion of registration requirements under present interpretations of the exemptive provisions."

Because of that position of the SEC, Respondent may not dispose of any securities of Appellant held by him until he has satisfactorily established that *all* securities acquired by him from Appellant for investment are *no longer under any restriction* upon their further transfer.

CONCLUSION

By reason of the foregoing, it must be concluded:

(a) Respondent's holding period of investment stock does not fulfill even the two year minimum spoken of by the SEC authorities;

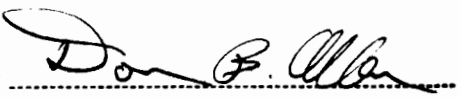
(b) No change of circumstances has been shown in fulfillment of another of the SEC's requirements;

(c) Respondent's more recently acquired investment stock with more restrictive investment representations requires all of his stock to be so held until registration.

Accordingly, Appellant requests this Court to reverse the lower court's final order and judgment, with consequent dismissal of the action.

Respectfully submitted,

RAY, QUINNEY & NEBEKER

By 

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