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AN ESSAY FOR PROFESSOR ALAN BROMBERG: REMOVING THE TAIN FROM PAST ILLEGAL OFFERS AND SALES

*Douglas M. Branson**

AT Northwestern, in Chicago, my mentor, in law school and subsequently, was Professor David S. Ruder, later dean of that law school and still later Chairman of the United States Securities and Exchange Commission (SEC).¹ I once asked David whom he most admired in the field of securities regulation. He mentioned two people: Robert Mundheim, then (1970) at the University of Pennsylvania School of Law,² and Alan Bromberg, who spent his professional career at Southern Methodist University.³

I did not meet Professor Bromberg face-to-face until eleven or twelve years after I left Northwestern. I was a newly elected member of the American Law Institute (ALI), attending the meetings each year and following closely the controversial *Principles of Corporate Governance and Structure*.⁴ The ALI Corporate Governance Project lasted for fourteen years, finally being codified in two volumes, in 1994.⁵ It was then, in 1981 or 1982, in the ballroom of the Mayflower Hotel in Washington, D.C., where the ALI held its annual meetings, that I met Alan.

He was extremely friendly to me, a young academic. Then, and at several subsequent ALI meetings, we kept up a running commentary over several days, about the ALI effort, about academics, a bit about securities regulation, and about a host of other subjects.

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1. See generally Douglas M. Branson, *Prescience and Vindication: Federal Courts, SEC Rule 10b-5, and the Work of David S. Ruder*, 85 Nw. U. L. REV. 613 (1991).

2. Robert Mundheim later became dean of Pennsylvania Law School. He left that position for Wall Street, rising to the position of General Counsel at Solomon Brothers. Currently, he is of counsel to the New York law firm of Shearman & Sterling. See generally SHEARMAN & STERLING PEOPLE, Robert H. Mundheim, <http://www.shearman.com/en/people/m/mundheim-robert-h> (last visited May 30, 2015).

3. The securities law area has always also been peopled by noted practitioners who have also an academic bent and frequently publish articles and books. The pantheon of practicing securities lawyers would include Richard Phillips, Frank Razzano, Steve Crimmins, Tom Gorman, and Ralph Ferrara, to name a few.

4. A. L. I., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* (1994) (2 volumes).

5. *Id.*

As a securities lawyer, too, I often have used Professor Bromberg and Lewis D. Lowenfel's multi-volume treatise, *Securities Fraud and Commodities Fraud*, the universally acknowledged "bible" in the subfield of securities law.⁶ Professor Bromberg authored many other books and law review articles.⁷ One of his obituaries recited that 2,494 law review articles, 348 federal court published opinions, and 171 state court opinions discuss and cite to Professor Bromberg's works.⁸

So, Professor Bromberg belongs in my securities law pantheon, by the side of Professors Louis Loss (Harvard), Adolf Berle (Columbia), Homer Kripke (New York University), Harold Marsh (UCLA), Dick Jennings (University of California - Berkeley) and a few other giants of the field. I write this tribute in his memory and out of both personal and professional gratitude for his friendship and guidance.

I. THE BROMBERG TEXT FOR THE DAY

Much like a preacher or a priest choosing a passage of scripture from the Bible, or a rabbi from the Torah, as the inspiration for a sermon, I have selected as my takeoff point a celebrated law review article Professor Bromberg published in the inaugural issue of the *Journal of Corporation Law* (University of Iowa School of Law), volume 1, at page 1, in 1975. The title of the article, encyclopedic in scope, is *Curing Securities Violations: Rescission Offers and Other Techniques*.⁹ I choose this particular piece because it is a subject with which I have dealt personally.

In my consulting, I advised on and helped structure several rescission offers. In my role as a frequent continuing legal education (CLE) speaker, I have covered that portion, the rescission offer portion, in day-long CLE programs on several occasions. I always begin preparation for advising or for speaking with a review of a well-thumbed photocopy of Professor Bromberg's seminal article.

Professor Bromberg's article is forty years old. The fundamentals, it seems to me, remain the same. There have been peripheral develop-

6. ALAN R. BROMBERG & LEWIS LOWENFELS, *BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD* (1994) (six editions subsequently published).

7. Other works include CHRISTINE HURT, ALAN R. BROMBERG, LARRY E. RIBSTEIN, & GORDON D. SMITH, *BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, & THE UNIFORM LIMITED PARTNERSHIP ACT* (2001); CHRISTINE HURT, D. GORDON SMITH, ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG & RIBSTEIN ON PARTNERSHIP* (2d ed. 2014); KAREN K. PORTER ET AL., *INTRODUCTION TO LEGAL WRITING AND ORAL ADVOCACY* (1989) (Alan R. Bromberg listed as the Chairperson of the Advisory Board); ALAN R. BROMBERG & MARK A. SARGENT, *BLUE SKY LAW TODAY: A PRACTITIONER'S GUIDE TO STATE SECURITIES REGULATION* (1987). A very early and pioneering work is ALAN R. BROMBERG, *SECURITIES LAW, FRAUD—SEC RULE 10B-5* (1967).

8. *Professor Bromberg Remembered*, SMU DEDMAN SCHOOL OF LAW (March 27, 2014), <http://www.law.smu.edu/News,-Headlines,-and-Articles/Faculty-News-Activites/Professor-Alan-Bromberg-remembered.aspx>.

9. Alan R. Bromberg, *Curing Securities Violations: Rescission Offers and Other Techniques*, 1 J. CORP. L. 1 (1975).

ments. But based upon my review, Professor Bromberg's article needs updating only a little bit, here and there.

II. ONE OF THE GREAT DIVIDES

Professor Bromberg advances as a dichotomy "technical [registration] violations" and antifraud rule violations (material misrepresentations or omissions in connection with the purchase or sale of a security).¹⁰ The two species of violation converge, here and there and later on, as many cases contain both sorts of violations. To begin his treatment, however, Alan makes the distinction.

The liability for registration violations is well-nigh strict. The only defense is that the seller of the securities had an exemption from registration.¹¹ Often, even if she does have a possible exemption, the going may be tough because the exemptions are strictly construed and the burden of proof is on the would-be user.¹² So, even though she may have had an exemption, the seller may not have documented her entitlement every step of the way. Her defense may fail because of problems of proof, that is, proof of entitlement to the exemption.

Under Securities Act section 12(a)(1), the liability is straight up-and-down; either you have a provable exemption or you do not.¹³ If the latter, you are liable for a recessionary measure of damages plus incidental and consequential damages, but minus any dividends or distributions that the entity has paid. The measure of damages does not include a deduction for any tax savings that inured to the purchaser as, for example, when the security whose sale has been rescinded was a tax shelter of some sort.¹⁴ The only wrinkle is that the section numbering has been changed since Professor Bromberg wrote. Section 12(1) has now become section 12(a)(1).

At first blush, antifraud violations seem much more problematic due to a myriad of changes since Professor Bromberg wrote. Just at the Supreme Court level alone, the changes include those wrought by the following cases:

10. *Id.* at 4-7.

11. *Id.* at 5.

12. Because an exemption is "an exception to the 'general policy' of the act [it] must be 'strictly construed' against the claimant of its benefit." *SEC v. Sunbeam Gold Mines*, 95 F.2d 699, 701 (9th Cir. 1938); *see also Hill York Corp. v. Am. Int'l Franchises, Inc.*, 448 F.2d 680, 691-92 (5th Cir. 1971); LOUIS LOSS, *FUNDAMENTALS OF SECURITIES* 400 (1983). The burden of proof is on the would-be user. LOUIS LOSS, *FUNDAMENTALS OF SECURITIES* 400 (1983); *see also Doran v. Petroleum Mgmt. Co.*, 545 F.2d 893, 899 (5th Cir. 1977); *Henderson v. Hayden, Stone, Inc.* 461 F.2d 1069, 1071 (5th Cir. 1972).

13. "Any person who (1) offers or sell a security in violation of section 77e [the registration requirement] . . . shall be liable . . . to the person purchasing such security from him." 15 U.S.C. § 771(a)(1).

14. *Randall v. Loftsgaarden*, 478 U.S. 647, 660 (1986) (holding that "actual damages" as used in the securities laws to describe the measure of damages under statutory remedies does not require a deduction therefrom for tax savings the plaintiff has achieved).

- In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court found an allegation of intent or possibly of recklessness is necessary to ground a Rule 10b-5 action for damages.
- In *Sante Fe Industries v. Green*, 430 U.S. 462 (1977), the Court held that an action will not lie for fully disclosed but highly unfair acts or practices; an allegation of deception is necessary.
- In *Painter v. Dahl*, 486 U.S. 622 (1988), the Court decided an antifraud action under Securities Act section 12(a)(2) will lie only as to actual sellers of securities and those who participate in the selling effort, receiving some economic or similar benefit therefor.
- In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), the Court eliminated use of aiding and abetting as a cause of action to hold liable collateral participants in Rule 10b-5 actions.
- In *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), the Court held that prospectus in Securities Act section 12(a)(2) does not mean any writing which offers a security for sale, as the statute's definitions indicate, but rather a traditional prospectus or similar disclosure document.
- In *Dura Pharmaceuticals, Inc. v. Brouda*, 544 U.S. 336 (2005), the Court reiterated that securities action plaintiffs must prove loss causation which includes eliminating confounding or intervening events.
- In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the Court rules out "scheme liability" as an attempt to re-impose secondary liability theories previously rejected by the Court.

The analysis of rescission offers and how one might work, though, remains largely the same, with little direct effect by the many Supreme Court decisions in the securities law field. Instead, the effect, if there is one, may be indirect. *Ex post*, the effect of all the Rule 10b-5 (securities fraud) decisions in the interim is to make it more difficult for a plaintiff to get an allegation of an antifraud rule violation to court and to trial on the merits of her claim. *Ex ante* then, the seller of securities and her adviser may have a changed view on the necessity of working a rescission offer, one that differs markedly from what their assessment might have been forty years ago, when Professor Bromberg first wrote. Today a plaintiff would have many more obstacles in her way and mountains to climb to bring any securities case to trial.

III. RESCISSION OFFER HYPOTHETICALS

A. HYPOTHETICAL ONE

Mike Jagger has a very profitable business that sells credit accident and health and credit life insurance in a four-state area in the Midwest. His agents sell to automobile and appliance dealers who in turn do the actual selling of the policies to customers who buy on credit. Mike, though, is a scratch golfer so he has formed a second subsidiary that will manufacture

and sell golf paraphernalia. He has raised money to pay for the expansion by selling shares in Jagger Enterprises. He touts the shares in the locker room of the country club to which he belongs, at the Rotary Club meetings he attends, in the diner where he and many of the town's business persons have lunch each day, and elsewhere. So far he has sold 29,400 shares to twenty-one purchasers, an average of 1,400 shares per transaction, at \$11.00 per share, for a total capital raise of \$323,400.00.

A difficulty though is that Mike has never disclosed that he personally owns 1,000,000 shares, with a book value of \$1.00 per share. Giving effect to the new sales, the new purchasers will suffer significant, immediate dilution of their shares (from \$11 to \$1.29) while Mike will have, on paper at least, a gain (from \$1.00 to the aforesaid \$1.29) at the new purchasers' expense. Mike did not disclose any of this. There was no disclosure document of any description.¹⁵ Last of all, an investigator for the state securities division has paid Mike a visit.

Mike comes to your law firm. He has big plans for development of his golf accessory company. He therefore does not want past events holding him back from raising capital going forward.

A rescission offer could be the answer. Mike and his company are extremely vulnerable because the facts of the Jagger Enterprises situation indicate the strong probability of registration as well as antifraud rule violations. The violations in his past can be "integrated" (the securities law term analogous to combined) with future transactions thought to be exempt.¹⁶ One possible effect of the integration may be that the dollar limits or limits on the numbers of purchasers may be exceeded, blowing the exemption Mike thought he had on the more recent transactions.¹⁷

15. Strictly speaking, one does not need a disclosure document in at least two instances, although it is customary to provide a deal specific disclosure document in all but the smallest of deals. First is when is the issuer is a 1934 Act reporting company. You merely provide the offerees and their purchaser representatives, if any, with the most up-to-date 1934 Act reports or point the potential purchaser toward them. See 17 C.F.R. § 230.502(b)(2)(C)(ii)(A)–(B) (2015). Second is when *all* the purchasers are accredited investors. 17 C.F.R. § 230.502(b)(1) (2015).

16. The explanatory note to SEC Rule 502(a): "The term *offering* is not defined in the Act[.]" "[T]he determination as to whether separate sales of securities are part of the same offering (*i.e.*, are considered *integrated*) depends on the particular facts and circumstances." The note then summarizes the common law integration factors:

- (a) Whether the sales are part of a single plan of financing;
- (b) Whether the sales involve issuance of the same class of securities;
- (c) Whether the sales have been made at or about the same time;
- (d) Whether the same type of considerations [e.g., cash] is being received;
and
- (e) Whether the sales are made for the same general purpose.

17 C.F.R. § 230.502 (2015) (explanatory note). The note cites SEC Release No. 33-4552 (November 6, 1962).

17. A danger here is to become overly technical but technical to some extent one must be. Combining the number of purchasers results from integration, causing, for example, an issuer to exceed the thirty-five-purchaser limitation of Rule 505. 17 C.F.R. § 230.505(b)(2)(ii) (2015). The safe harbor is outside of six months. Aggregation is somewhat different, causing the issuer to exceed dollar amount limitation. The aggregation safe harbor, if you will, is twelve months, or outside of twelve months. See, *e.g.*, 17 C.F.R.

Such limitations may exist under federal law; they are quite common under state law limited offering exemptions.

Another effect is that as long as those securities violations are lurking in Mike and Jagger Enterprises' past, a contingent liability exists in the present. Subsequent purchasers could sue for failure to disclose the possible effect of the past violations, effects which could result if the earlier purchasers become dissatisfied and sue. Footnotes to the balance sheet must disclose contingent liabilities.¹⁸ Chances are that Mike or his accountants never thought of this. So the offers to the new purchasers in the latest transaction give rise to antifraud rule violations. Those second round purchasers, those to whom the contingent liabilities were not disclosed, could sue too.

1. *Solving the Problem*

Mike and Jagger Enterprises are vulnerable both on the federal level and in each state in which Mike made the illicit sales. So the law firm partner with whom Mike first consulted attacks the federal problem first. He outlines a recessionary offer which would meet the SEC staff's ideas about how a rescission offer should be conducted, which is very demanding.

By and large, the SEC opines that to be effective, a rescission offer must contain adequate and balanced factual information (not too positive (no hype)) but not too negative either (in case the enterprise succeeds later on); the rescission offer must be made simultaneously to all purchasers in the offering or round in which the violations occurred; and the rescission must contain same day money (a cashier's or bank check for the full recessionary measure should be in each and every envelope).¹⁹

The law firm begins working its client, Mr. Jagger, out of this predicament by removing the taint of past illegal offers and sales by outlining a proposed rescission offer in a letter to the SEC. The law firm then makes a request to the Commission: if the client did as the letter outlined, would the SEC take no action? Further, would the SEC issue a letter ("no action letter") to that effect?

The SEC issues the letter. The law firm partner telephones Mike Jagger with the news. Mike is pleased but grumbles about the legal fees he and his company have already incurred. Okay so far.

Then comes the showstopper. The partner fills in the client about phase two, the actual rescission offer. Following traditional SEC guidelines, the

§ 230.504(b)(2) (2015); Rule 505(b)(2). Rule 504 exempts offerings up to \$1 million. Rule 505 is an exemption for offerings up to \$5 million.

18. If the contingent liability becoming reality is imminent, the reporting entity may have to establish a reserve on the balance sheet, or accrue a loss against earnings. STATEMENT OF FINANCIAL ACCOUNTING STANDARD (SFAS) NO. 5, ACCOUNTING FOR CONTINGENCIES, ¶ 8, 9 & 33 (March 1975); LAWRENCE A. CUNNINGHAM, INTRODUCTORY ACCOUNTING AND FINANCE FOR LAWYERS 104 (2002).

19. See, e.g., Bromberg, *supra* note 9, at 22 ("[t]he SEC typically presses for this"), 28 ("an offer made without the ability to perform would probably be fraudulent").

attorney tells the client that he would simultaneously have to send “same day” money to the twenty-one purchasers. “You mean I will have to come up with \$323,400.00, or even a bit more, in cash?” the client queries. “I will need some time to raise the money,” (or “think it over,” or some other excuse).²⁰

The client (Mike Jagger) walks and is never seen again.

There is the rub. If a securities attorney attempts to follow the traditional SEC or many states’ guidelines concerning working a rescission offer, in all probability, two things will happen: one, she will lose a client and; two, no rescission offer will ever eventuate. Instead, the client may “go naked,” proceeding without legal advice, making offers and sales of securities in Series or Round B financing and, a short while later, in Series C and other capital raises. Or, she (the client) may walk down the street until she finds an attorney who will cut corners and offer her as the new client more palatable advice.

Several questions arise. Among them, must a rescission offer be fully funded at the outset? Are partial, or “rolling,” offers (versus all holders) rescission offers acceptable?

B. HYPOTHETICAL TWO

Hopper, Ltd., engages in the seemingly pedestrian business of research and development for railcar manufacturing. The company is the brainchild of several retired aeronautical engineers whose business plan is to adapt weight-saving and other efficiency measures developed in the aircraft industry for use in railcar manufacture. Lighter axles or more compact braking systems translate into improved fuel consumption and less roadbed wear-and-tear.

Hopper is a management company. For each new project, it forms a separate limited partnership or limited liability company (LLC). Hopper raises \$1 million funding for each research and development (R & D) entity whose role is to develop a prototype and apply for a patent. The monkey wrench in the works, though, is that these entities frequently run out of cash before they reach the final, or “n,” stage of a particular project. That’s easy, though: if entity A had a shortfall of \$300,000, merely have entity A borrow from entity B. Entity B, now already behind the eight ball, may fall further short. It borrows from entity C, and so on, on down the line.

If you co-mingle funds like that, in whatever field you are in, real estate development, for example, the sales used to fund the apparently separate

20. “The issue of whether a rescission offer can be made without the ability to pay every person who accepts the offer has not been responded to uniformly by federal and state regulators.” Michelle Rowe, *Rescission Offers Under Federal and State Law*, 12 J. CORP. L. 383, 409 (1987) [hereinafter Rowe]. Apparently, the SEC has backed away from its hardline position: “[t]he Commission’s current position appears to be that the rescission offer may be made if disclosure is made of the inability to fund the offer fully.” *Id.* But an increasing number of states either in regulations or policy statements do not agree with that position, requiring that the offer be fully funded. *Id.* at 409–10, 409 n.202.

entities may be integrated.²¹ The result is that a violation in any one of the separate offers (private placements or intrastate offerings) will now infect all of the entities. One registration or one antifraud rule violation in the past, in only one of the related entities, may sink the entire ship.

You may also have an antifraud violation if the later offerings described the use of proceeds, as most disclosure documents do. The disclosure, for instance, may have said to develop a prototype for a new design of railroad freight car axle. The actual use of a material amount of the offering proceeds has been to fund a previous partnership or LLC. Ergo, a misrepresentation exists in the subsequent offerings' private placement memorandum or other disclosure document.

The Hopper example is small potatoes. The "rob Peter to pay Paul" scenario can occur in much larger entities. Private equity and venture capital firms often have a similar model in which they are repeat players.

For example, a management company exists off to one side. Investors fund a series of limited partnerships or LLCs for various amounts: LLC One for \$800 million; LLC Two for \$1.2 billion; LLC Three for \$900 million; and so on. If LLC One needs \$100 million to complete its final acquisition, it may borrow the money from LCC Two, and so on. The possibility of integration again raises its ugly head.

The borrowing and journaling of money back and forth is okay, perhaps, if the promoters in the management entity thought about it in advance. The private placement disclosure documents (private placement memoranda, or PPMs) used to raise funds for the various entities could clearly disclose that the related entities may borrow funds from one another (use of proceeds section); cap the extent of such borrowings; provide for a demand or perhaps a shorter term promissory note; and have a formula, at least, for computing an interest rate on the obligation (the weighted cost of capital, for example). Related entities can deal with one another, if they disclose in advance the possibility that they may do so and they keep it above board and well-documented.

But, whether in New York City or Palo Alto, promoters often do not anticipate the problem or deem it highly unlikely. If you give the type of rescission offer advice the attorney gave in the Jagger Enterprises hypothetical, *supra*, the proposed solution is even more unworkable. For one, the numbers and thus the stakes are much larger. Two, the capital may be more irretrievably sunk into a portfolio company investment, making it much more difficult to pull out and use in a rescission offer.

Attorneys frequently have to give advice the client does not wish to hear. That is doubly or triply true in this situation. But the prospect of having to render doomsday type advice, that the client has to undertake a rescission offer and that, to be absolutely safe, the offer should be to all

21. SEC v. Murphy, 626 F.2d 633, 645 (9th Cir. 1980), is the leading case. See also JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 337-38 (4th ed. 2004).

holders and fully funded, may draw an attorney back to the drawing boards.

IV. ALTERNATIVES TO RESCISSION OFFERS (FULLY FUNDED)

In a prior life, Mike Jagger, *supra*, was known as Mick and sang, "Time is on Your Side." Perhaps the same is true here. To press the reset button, the issue is what will remove the taint of past registration or antifraud rule violations that can be implemented on more recent securities offerings? A rescission offer has been a standard solution for the problem. Another solution may be simply the passage of time.

The integration safe harbor under SEC Regulation D is six months.²² After more than six months have passed, an issuer can go back to the Regulation D "well" once again, say, conducting a Rule 505 offering following a previous Rule 504 transaction. Is then the passage of six months sufficient to erase the taint of a past securities law violation?

No, it is not, because the safe harbor is only for the timing of exempt transactions. Unless the violation was "innocent and inadvertent" ("I & I"),²³ one or possibly both offerings would not be within the rule. For starters, the later proposed offering would not meet the safe harbor, unless it clearly disclosed the contingent liability arising from the past registration or antifraud violation, which it most likely did not. The earlier offering, because it and the later offering have been integrated, thus blowing the Rule 504 exemption, would not be either.

What about the other extreme, the passage of a long time, longer than six months? Well, the longtime does not seem to have to be too long but the entire area is akin to what Charles Dickens said of Chancery Court, "Fog - everywhere."²⁴

The applicable statute of limitations would define the outer limit, or point in time, after which the taint of previous violations could be viewed as erased and the offeror largely "home free."²⁵ Those aggrieved by the past violation could no longer seek judicial redress. The predicament would have disappeared.

The statute of limitations here is a short one. Securities Act section 13 provides that

[n]o action shall be maintained to enforce any liability created under section 77k or 77l(a)(2) of this title [another antifraud rule] unless

22. 17 C.F.R. § 230.502(a) (2014) ("Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of the Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class . . .").

23. See 17 C.F.R. § 230.508 (2014) (titled "Insignificant Deviations from a Term, Condition or Requirement of Regulation D").

24. CHARLES DICKENS, *BLEAK HOUSE* 1 (1853) (Modern Library ed. 1985).

25. Paul D. Rheingold, *Solving Statutes of Limitations Problems*, 4 AM. JUR. TRIALS 441, § 2 (1966).

brought within one year . . . or, if the action is to enforce a liability created under section 77l(a)(1) [registration violation] if this title, unless brought within one year after the violation upon which it is based.²⁶

For antifraud violations generally, historically, the Securities Exchange Act of 1934 contained no statute of limitations that would be expressly applicable to actions for Rule 10b-5 (the catchall antifraud rule) violations. The federal courts therefore borrowed a closely analogous federal securities law statute of limitations: namely, that applicable to causes of action for illegal manipulation. That statute stated that “[n]o action shall be maintained . . . unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.”²⁷

The Supreme Court approved of lower courts’ borrowing a statute for a Rule 10b-5 action.²⁸ In 2002, however, Congress enacted a catchall statute of limitations for securities law violations, which included antifraud rule violation claims.²⁹ That statute provides for a limitation of actions “2 years after discovery of the facts constituting the violation” or “5 years after such violation.”³⁰

The kicker, which may extend the time considerably in both cases, is the incorporation of a discovery rule as well. Securities Act of 1933 section 13 adds to “one year” the qualifier “or after such discovery should have been made by the exercise of reasonable diligence.”³¹ The statute applicable to antifraud claims is “2 years after discovery of the facts constituting the violation.”³²

Faced with choices as to what that means, the Supreme Court faced a choice between actual knowledge (the statute does not begin to run until the putative plaintiff actually knew) and “inquiry notice” (the statute begins to run when “a plaintiff possess a quantum of information sufficiently suggestive of wrongdoing that he should conduct further inquiry”).³³ In *Merck & Co. v. Reynolds*,³⁴ the Court settled on a middle course, that the statute would not begin to run until “a reasonably diligent plaintiff would have discovered the facts constituting the violation, including scienter—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation.”

26. 15 U.S.C. § 77m (2012).

27. 15 U.S.C. § 78i(f) (2012) (also codified in the Securities Exchange Act of 1934 §9(f)).

28. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 & n.9 (1991).

29. *See Merck & Co. v. Reynolds*, 130 S. Ct. 1784, 1790, 1795 (2010).

30. 28 U.S.C. § 1658(b) (2012).

31. 15 U.S.C. § 77m (2012).

32. 28 U.S.C. § 1658(b) (2012).

33. 130 S. Ct. 1784, 1797 (2010).

34. *Id.* at 1798 (internal quotation marks omitted).

So, the lengthening of the limitations period bought on by a discovery rule add-on stretches the time to when an absolute time bar would intervene.

The only sure time bar would then be the statute of repose: “[i]n no event shall any such action be brought . . . more than three years after the security was bona fide offered to the public” for registration violations.³⁵ For antifraud claims, the absolute bar (the statute of repose) does not kick in until five years have passed. That lengthens the cutoff by the passage of time even more so.

Nonetheless, many securities lawyers opine that the passage of more than a year since the last violation will cure the taint imposed by a past violation, freeing the issuer of securities to consider return to the use of exemptions from registration to raise additional capital. No securities lawyer, or at least none that I know of, would write an opinion letter to that effect. Most, perhaps all, would also refrain from putting such a statement in any writing whatsoever (letter, memo, email, etc.). You will also search in vain for authority for that proposition.

Lawyers, too, add a qualifier. The passage of one year will remove the taint of past illegalities, at least if the violation was not too egregious, whatever that means. Mick Jagger’s sale to twenty-one purchasers, aggregating \$324,400 just might fall into the egregious category, especially if he sold to purchasers not able to fend for themselves.

A point then is that the “street law” one-year rule of thumb is extremely mushy. A careful lawyer is not going to rely on the maxim for cases involving large dollar amounts or the client’s brazen or repeated past disregard of the securities laws.

V. PARTIAL OR IN SERIATIM RESCISSION OFFERS

Well, what if the attorney had taken a middle course, first asking Mike Jagger what the art of the possible might be? Assume Mike answered that he could probably lay his hands on \$75,000 in liquid assets, that is, cash or items easily turned into cash, versus the \$323,400 that would be needed to fund fully an all holders offer.

Because Mike’s typical purchaser invested \$15,000, more or less, Mike’s \$75,000 allotment could fund rescission offers to five purchasers. The offer could keep each investor to whom it was made on a relatively short leash, say twenty or thirty days. If the checks had not cleared his bank after that time, Mike could stop order the checks, going on to make the same offer to the next five investors. He would thus conduct a “rolling rescission offer” rather than a same day funds deal to everyone at once.³⁶

35. 15 U.S.C. § 77m (2012).

36. Whether the offer must be extended to everyone (insiders excluded) is an open question. Rowe, *supra* note 20, at 410–11. By an analogy of rescission offers with tender offers (both are offers to buy), however, Ms. Rowe seems to believe that the tender offer regulations, including the SEC’s “All Holders” Rule, SEC Rule 13e-4 (“Issuer Tender Of-

Or, rather than sending a check with each written offer to rescind, Mike could escrow an amount to fund, partially at least, the rescission offers made or to be made. Would these alternatives make the idea of a rescission offer more palatable to Mike?

The SEC or a state regulator might object to these alternatives. For one, if the first five, six, or seven investors decided to rescind, the available fund would have been exhausted. Equally injured by the past violations, the remaining fourteen, fifteen, or sixteen investors would remain high and dry. The limited fund feature of the rolling rescission offer would seem to doom it.

For these reasons, the SEC staff has rejected the idea of an in seriatim or rolling rescission offer. No court, however, seems to have dealt with the issue, at least in a published opinion.

What if the issuer conducting a rescission offer layered, say, a bank line of credit over top of a fund adequate for the first third or half of the investor group to whom rescission offers were addressed?

A matter to keep in mind is that the SEC staff's view has been that the high road (their road) is the only road. A court may be more sympathetic to a rescission offer conducted in good faith even though it had not been fully funded *ab initio*. The court may hint, or find, that the staff's opinion is just that, merely the staff's opinion. Then, too, SEC enforcement personnel do not have infinite resources; they may be accepting of a well-crafted though less than fully funded rescission offer.

VI. QUALITY OF THE DISCLOSURE

Any well-crafted offer would include a disclosure document. The substantive disclosure, that is, about the issuer and its prospects, should be evenly balanced.

The lesser and least likely problem is that the rescission offer disclosure is too negative. Negative disclosure could lead to subsequent claims by those who had rescinded. Those claims would most likely arise in the case in which the venture went on to success or, still more likely, when the venture went on to extraordinary success.

Rule 10b-5, of course, applies to purchases as well as sales. An offer to rescind would be an offer to purchase. In this scenario, a very probable allegation by the seller, who had forgone profits by rescinding, may involve insider trading. The cases are legion in which an insider persuaded a shareholder to sell by painting a negative picture when the insider knew that the future was indeed very bright. In one case, a bank director

fers"), would apply. Confusing the picture, the Rule does contain a provision making the all holders concept inapplicable to a rescission offer that has been registered. But overall, the Rule applies only to tender offers. A rescission offer most decidedly is not a tender offer. *See infra* notes 53-57 & text accompanying: the all holders rule does not apply, and under federal law room exists, in theory at least, for a partial or rolling rescission offer. But what the right hand (the feds) might give, the left hand (certain state securities regulations) take away. Several states expressly forbid partial rescission offers. *See, e.g., Rowe, supra* note 20, at 411 & n.215 (California, Illinois, Nebraska).

painted a negative picture, knowing that an acquisition of the bank at a much higher share price was in the offing.³⁷ In another case, an insider disclosed a flat and dreary outlook for an agricultural corporation's shares, knowing that the City of Denver would probably purchase the corporation so as to build its new airport on the corporation's land holdings.³⁸

By far, the bigger danger would be of substantive disclosures that are too rosy, painting a favorable view of the issuer and its prospects in the hope that few, if any, of the holders of shares or units would rescind. Such Pollyannaish disclosure should be avoided at all costs.

The drafter has to give equal prominence to both the positive and to the negative, disclosing like facts (positive and negative) in similar format. She has to eschew any notion of burying facts, such as putting descriptions of possible negative consequences in an exhibit rather than the text.

To work a rescission offer that stands a good chance of holding up under subsequent analysis, the offer should be accompanied by a Goldilocks disclosure: not too negative, on the one hand, not too rosy and bright, on the other. The attorney crafting a disclosure document should seek to insure that the disclosure is "just right."

De rigueur any disclosure document would contain information about the mechanics of the offer, such as:

- if the issuer has paid dividends, then the rescission amount would be reduced by the amount of the dividends received;
- the number of days the rescission offer would be open;
- the method of acceptance;
- the effect of the rescission offer, if accepted by certain numbers of purchasers, on the issuer (for example, whether it will or will not endanger the issuer's financial condition or expansion plans);
- a statement maintaining a rescission offer does not bar federal or state authorities from filing an enforcement action.³⁹

The rescission offeror is not, however, required to admit that a violation or a probable violation has occurred or is a motive for the offer.⁴⁰

VII. A RESCISSION OFFER IS AN OFFER

At times, books, articles, and law cases must remind securities practitioners that registration requirements apply to offers to buy as well as

37. *Bailey v. Vaughan*, 359 S.E.2d 599, 600-02 (W. Va. 1987).

38. *Van Shaack Holdings. Ltd. v. Van Shaack*, 867 P.2d 892, 894-95 (Colo. 1994).

39. The traditional SEC position has been that "liabilities under the Federal securities laws . . . are not terminated merely because potentially liable persons make a registered [or any other] rescission offer." Gale R. Mellum, SEC No-Action Letter, 1975 WL 11392 (July 21, 1975). By contrast, all but six states have statutes expressing the contrary. All civil liability actions will be barred if, before suit has been filed, the issuer made and the purchaser received a written offer to refund the consideration she has paid plus interest. *See, e.g., Rowe, supra* note 20, at 424.

40. *See Rowe, supra* note 20, at 414 & n.243.

offers to sell a security. The Securities Act of 1933 definitions section provides that the term "Sale", "sell", "offer to sell", or "offer for sale" includes every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."⁴¹

The consequence to the inclusion of offers to buy means that an offer, such as a rescission offer, must itself be registered or have an exemption from registration.⁴² Otherwise, the rescission offer itself will constitute a violation of the Securities Act of 1944, section 12(a)(1). Ordinarily, in smaller deals, an exemption from registration will exist for a rescission offer, say, for an interstate offering or a private placement (really an unplacement).

Issuers of securities seeking to cure or erase the taint associated with widespread past securities law violations every once in a while file a registration statement regarding the rescission offer. Or, at least, there are several reported judicial opinions indicating that issuers of securities have done so.⁴³

According to a knowledgeable SEC staff attorney, the inclusion of offer to buy "has been interpreted narrowly and is deemed to apply to offers to buy made by a dealer."⁴⁴ On the state level, most Blue Sky laws provide offers to buy, which, like rescission offers, are not deemed subject to registration requirements. Only the states' antifraud statutes govern.⁴⁵

So, according to one view, having an exemption from registration, or having to register, is one additional complication that a practitioner need not have at the forefront of her mind. The opposing view would be that the federal authorities are older and scant. Under that view, when attempting to erase the taint of a prior violation of the securities laws, a practitioner should regard a rescission offer as an event possibly triggering a need to register or have an exemption for the proposed transaction, and act accordingly.

VIII. IS A RESCISSION OFFER A TENDER OFFER?

In 1969, Senator Harrison Williams of New Jersey (later indicted and convicted in the Abscam Prosecutions—still later depicted in the 2013 film *American Hustle*) introduced amendments to the Securities Exchange Act to regulate tender offers, also known as takeover bids, then

41. 15 U.S.C. § 80a-2(a)(32) (2012).

42. See, e.g., Rowe, *supra* note 20, at 393 ("[T]he rescission offer will be an offer to sell the security.").

43. See, e.g., Smith v. XIAN Foods Corp., 1988 WL 96560 (N.D. Ill. 1988); Brucker v. Thyssen-Borremisza Europe, N.V., 424 F. Supp. 679, 690 (S.D.N.Y. 1976).

44. Rowe, *supra* note 20, at 393.

45. See 15 U.S.C. § 78bb(a)(4) (2012).

relatively new to the United States.⁴⁶ The legislation, which is quite brief, requires a status filing (SEC Schedule 13D) by anyone acquiring 5% (for a short initial period 10%) of a publicly held company.⁴⁷ The amendments to section 14 require a similar filing (Schedule 14D) by anyone who commences a tender offer for shares of a public company, whether they have previously crossed the 5% mark or not.⁴⁸ The disclosures required are quite brief.

Unlike most of federal securities regulation, which traditionally has been based upon disclosure, the Williams Bill introduced substantive requirements with which a bidder also must comply.⁴⁹ They are:

- A 21-60 day rule: an offer must be open at a minimum for 21 days and after 60 days the bidder must return all securities which have been tendered but not paid for.⁵⁰
- A pro-rata take-up rule: if a tender offer is a partial bid (say, for 30%, or 55% or anything less than “any and all”), and the offer is oversubscribed, the bidder must take up pro rata the shares of all shareholders who have tendered (cannot take up 100% of friends’, associates’ or affiliates’ shares and just 10% or 20% of strangers’ stock).⁵¹
- An increase in consideration rule: a bidder who, during the course of an offer, raises the bid it proposes to pay must pay the increased consideration to all who have tendered, including those who tendered before the increase as well as to those who have tendered afterward.⁵²

In a highly detailed, technical exposition, a former SEC attorney assumes that because the two, tender offers and rescission offers, are essentially the same being offers to buy, that the Williams Bill, including the substantive provisions just reviewed, would apply to a rescission offer.⁵³ Were that the case, if a partially funded rescission offer was over-subscribed, the issuer would be legally required to spread the available con-

46. U.S. tender offer legislation and the background of its adoption are described in Douglas M. Branson, *Some Suggestions from a Comparison Between British and American Tender Offer Regulation*, 56 CORNELL L. REV. 685, 691-704 (1971).

47. 15 U.S.C. § 78m(d)(1) (2012) (codifying The Securities Exchange Act of 1934 § 13(d)(1)).

48. 15 U.S.C. § 78n(d) (2012) (codifying The Securities Exchange Act of 1934 § 14(d)(1)).

49. See, e.g., Robert W. Hamilton, *Some Reflections on Cash Tender Offer Legislation*, 15 N.Y.L.F. 269, 274-75 (1969) (“While Congress chose to follow the general disclosure philosophy underlying federal regulation of proxy contests and public exchange offers, it recognized that cash tender offers posed certain unique problems. Public Law 90-439 [the Williams Bill] therefore goes considerably beyond disclosure in connection with cash tender offers, and requires certain substantive changes in cash tender offer practice.”).

50. 15 U.S.C. § 78n(d)(5) (2012) (7-60 day rule) (this statute is modified by the 21-60 days rule, 17 C.F.R. § 240.14e-1 (2012)).

51. 15 U.S.C. § 78n(d)(6) (2012) (codifying The Securities Exchange Act of 1934 § 14(d)(6)).

52. 15 U.S.C. § 78n(d)(7) (2012) (codifying The Securities Exchange Act of 1934 § 14(d)(7)).

53. See, e.g., Rowe, *supra* note 20, at 399-401 (applicability of SEC tender offer rule, Rule 13e-4, without analysis of whether a rescission offer is a tender offer).

sideration over all those holders who had accepted the offer (say, 60% to each rather than 100% to some and 30% to others).

The wisdom of that alternative aside, that is only half the story. Is it legally required to do so?

The Williams Bill never actually defined the term "tender offer." A shorthand definition many securities lawyers use is that a tender offer is an offer to buy that seeks control or a measure of control over the takeover target. So tender offers and rescission offers are not, after all, analogous. Presumably, the person making the rescission offer already is in control, that is, in "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."⁵⁴

But it's more complicated than that. Through the Williams Bill's early years, the question of "what is a tender offer?" continued to plague courts, at least until a federal district court judge rolled up his sleeves, outlining a seven point test of what constitute a tender offer. That test has stood the test of time: it continues to be utilized by federal courts when pressed to decide whether or not they have subject matter jurisdiction under the Williams Bill, applicable as to "tender offers."⁵⁵

The *nisi prius* decision was by Judge Carter of the Southern District of New York in the case of *Wellman v. Dickinson*.⁵⁶ Taking advantage of the inexact boundary line between what is a private purchase and what is a tender offer, a bidder made a direct offer to 30 institutions holding over 20% of the shares of medical supply company Becton, Dickinson & Company. The would-be acquirer of shares offered a substantial premium over market value. It also gave the holders one hour to accept or reject the bid. Twenty two of the 30 institutions accepted, yielding over the desired 20% to the bidder. Was that direct purchase, styled by some as a Saturday Night Special, a tender offer and thus subject to the Williams Bill?

Judge Carter listed "seven elements as being characteristic a tender offer":

- (1) [A]ctive and widespread solicitation of public shareholders . . . ;
- (2) [S]olicitation made for a substantial percentage of the issuer's stock;
- (3) [O]ffer to purchase made at a premium over the prevailing market price;
- (4) [T]erms of the offer are firm rather than negotiable;

54. 17 C.F.R. § 230.405.

55. See, e.g., *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985); Sutton Keany & Robert J. Sussman, *The Elusive Definition of Tender Offers*, 46 BROOK. L. REV. 1045 (1980); Barbara J. Thomas, *Securities Regulation—Effectiveness of Withdrawal of A Cash Tender Offer—Field v. Trump*, 850 F.2D 938 (2d Cir. 1988), cert. denied, 109 S.Ct. 112 (1989), 62 TEMPLE L. REV. 1033 (1989).

56. 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982).

- (5) [O]ffer contingent on the tender of a fixed number of shares, often subject to a fixed maximum . . . ;
- (6) [O]ffer open only a limited period of time;
- (7) [O]fferee subjected to pressure to sell his stock.⁵⁷

Clearly, under the *Wellman v. Dickinson* matrix, a rescission offer would not be a tender offer, contrary to what a technical or overly technical analysis might point to, for several reasons.

One, the solicitation may not be widespread. The issuer may attempt merely to offer to rescind, say, those purchases made in the series C round of financing for the venture.

Two, the offer may not be made for a substantial percentage of the issuer's stock. Again, the rescission sought might be for one or two misguided past sales, or one series or round of financing.

Three, an issuer never makes a rescission offer having regard to the market price at all. The frame of reference always is the amount the past purchasers paid for the stock.

Four, a rescission offer never is contingent on a certain number of persons rescinding. Indeed, from the standpoint of preservation of the issuer's cash, the fewer takers the better.

Five, an issuer making a rescission offer is in enough hot water as it is, having committed past violations and thus blotted its copy book. The issuer would be extremely unwise to pressure recipients, in this case not to take the offer.

A rescission offer could be a tender offer in a very limited set of circumstances, I suppose, but to include in a main stream discussion the subject of tender offer regulation as a possible further regulatory obstacle goes well beyond dotting the i's and crossing the t's.

IX. CONCLUSION

A rescission offer under the securities laws is one of those deceptive subjects. Seemingly simple and straightforward at first blush, the subject quickly ratchets up in complexity and may become a conceptual ball of snakes. Indeed, as has been seen⁵⁸ in one of the principal articles following Professor Bromberg's pioneering work, the author lets the subject get out of control. The result is a mind-blowing welter of conceptual questions and regulatory labyrinths and cul-de-sacs.

Professor Bromberg's analysis is probably all the grounding a practitioner needs on the subject of rescission offers and the erasure of the taint generated by past misdeeds. Indeed, Professor Bromberg's exposition may contain significantly more than a practitioner would need. In this article, I have attempted to present the subject in terms of settings a securities lawyer is likely to encounter, giving the theoretical issues more texture and feel.

57. *Id.* at 823-24.

58. *See, e.g., supra* notes 20, 36, 42-44 & 53-57 & accompanying text.

I also believe that the subject, removing the taint of past illegal offers and sales, will become increasingly important as we move along in this new knowledge economy. The startups, entrepreneurial ventures, and incubator facilities in the high tech, health care, biotech, and similar fields multiply geometrically all around us. Many of these fledgling enterprises are peopled with individuals highly proficient in what they do but relatively naïve from a business and especially from financial and legal-financial points of view. Mostly inadvertently, they will violate federal and state securities laws and regulations.

From a securities law standpoint, even with the new crowdfunding and other legislative innovations intended to free capital raising from regulatory burdens and constraints,⁵⁹ entrepreneurs and promoters will still make these mistakes. It is equally important for the counselor and adviser to be able to advise on what the stakes and the consequences are, as well as to master the ins and outs of working a rescission offer. Knowing what the stakes down the road are, or may be, goes a long way toward creating incentives for those persons to avoid mistakes in the first place.

Professor Bromberg always excelled at this sort of thing. He maintained strong professional relations with law firms in Dallas as well as with numerous practitioners across the United States. His métier was that intersection where theoretical and academic business organizations and securities law, on the one hand, and real world problems, on the other, meet. I think that he would approve of this article, which seeks to fit a theoretical problem into real world sets of circumstances.

59. *But see* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert judgments that Begs for A Happy Ending*, 102 Ky. L. J. 865, 888 (2014) (Crowdfunding “introduces new regulation and attendant costs to a magnitude and in a manner likely to drive many, if not most, small businesses to other capital formation methods.”).