

Private Offering of Securities under the Illinois Securities Law - Judicial Changes and the Need for Further Amendment

Roger G. Fein

Steven Bright

Follow this and additional works at: <http://via.library.depaul.edu/law-review>

Recommended Citation

Roger G. Fein & Steven Bright, *Private Offering of Securities under the Illinois Securities Law - Judicial Changes and the Need for Further Amendment*, 31 DePaul L. Rev. 307 (1982)

Available at: <http://via.library.depaul.edu/law-review/vol31/iss2/3>

This Article is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Law Review by an authorized administrator of Via Sapientiae. For more information, please contact mbernal2@depaul.edu, MHESS8@depaul.edu.

PRIVATE OFFERING OF SECURITIES UNDER THE ILLINOIS SECURITIES LAW—JUDICIAL CHANGES AND THE NEED FOR FURTHER AMENDMENT

Roger G. Fein*

Steven Bright**

The Illinois Securities Law of 1953¹ regulates the sale² of securities³ in Illinois. Under the Illinois Securities Law, all securities must be registered⁴ prior to sale unless they are statutorily exempt.⁵ According to section 4 of the Illinois Securities Law, a sale of securities to a small number of purchasers or of a small dollar amount is exempt and does not require registration with the Securities Department of the Secretary of State.⁶ Although such small security offerings are exempt from registration, a report of sale must be filed with the Securities Department pursuant to section 4G of the Illinois Securities Law.⁷ Filing a report of sale provides the state with a

* Partner, Arvey, Hodes, Costello & Burman, Chicago, Illinois; B.S., University of California at Los Angeles; M.B.A., American University; J.D., Northwestern University. Mr. Fein was formerly with the United States Securities & Exchange Commission. He is a member and was former Chairman of the Securities Advisory Committee to the Illinois Secretary of State. He is a liaison to the North American Securities Administrators Association and to the Illinois Securities Commissioner from the American Bar Association's State Regulation of Securities Committee.

** Associate, Arvey, Hodes, Costello & Burman, Chicago, Illinois; B.S., Northwestern University; J.D., DePaul University.

1. ILL. REV. STAT. ch. 121½, §§ 137.1-.70 (1979) [hereinafter cited as Illinois Securities Law or the Act]. The Illinois Securities Law was enacted to protect the public from unscrupulous stock promoters by requiring registration and approval of securities by the Securities Department of the Secretary of the State. *Levine v. Unruh*, 99 Ill. App. 2d 94, 240 N.E.2d 521 (2d Dist. 1968). The Act also protects the public from the dishonesty, ignorance, and irresponsibility of persons engaged in the business of disposing securities of uncertain value. *Stein v. Twilight Motel, Inc.*, 29 Ill. App. 2d 131, 172 N.E.2d 642 (1st Dist. 1961). For a comprehensive codification of the recent rules and regulations promulgated under the Illinois Securities Law, see 1A BLUE SKY L. REP. (CCH) ¶¶ 22,101-23,730.

2. The definition of the term sale includes every disposition or attempt to dispose of a security for value. ILL. REV. STAT. ch. 121½, § 137.2-5 (1979).

3. The Act's definition of security is extremely broad. In addition to commonly known securities, such as notes, stocks, and bonds, securities also include certificates of interest, participations in any profit sharing agreement, and fractional undivided interest in mineral leases. ILL. REV. STAT. ch. 121½, § 137.2-1 (1979).

4. Registration of securities follows a procedure delineated in §§ 5 and 7 of the Act. ILL. REV. STAT. ch. 121½, §§ 137.5, .7 (1979). See generally Cronson, *Problems of Registration*, 1961 U. ILL. L.F. 225.

5. The Illinois Securities Law requiring the registration of the sales of securities with the Secretary of State does not apply to certain exempt securities and to specific exempt security transactions. See ILL. REV. STAT. ch. 121½, §§ 137.3, .4 (1979).

6. ILL. REV. STAT. ch. 121½, § 137.4 (1979).

7. ILL. REV. STAT. ch. 121½, § 137.4(G) (1979) [hereinafter cited as 4G or section 4G].

source of revenue,⁸ and ensures a seller that the sale may not be voided due to ministerial noncompliance.⁹

The purpose of this Article is to evaluate the utility of the section 4G filing requirement. Important decisions rendered under this provision are discussed and problems posed by section 4G are analyzed. Finally, it is proposed that section 4G be amended to either eliminate or modify the filing requirement. The proposed revisions would render the Illinois Securities Law more workable and useful for small businesses in their capital raising efforts.

STATUTORY PROVISIONS

Section 4G sets forth the primary method for exempting "private offering" securities transactions from registration under the Illinois Securities Law.¹⁰ Under section 4G, sales of securities completed during a twelve

Section 4G provides in full:

The sale or sales of securities, other than fractional undivided interests in an oil, gas, or other mineral lease, right or royalty, for the direct or indirect benefit of the issuer thereof, or of a controlling person, whether through a dealer (acting either as principal or agent) or otherwise, within the 12 months preceding the point in time immediately after the last such sale or sales made in reliance on this subsection G (a) to not more than 35 persons in this State; or (b) if the aggregate selling price of the securities does not exceed \$50,000 provided that offers to sell such securities are not made to more than 70 persons in this State during such period of 12 months and that in determining such 35 persons or such 70 persons, as the case may be, there shall be excluded (i) purchasers or offerees of securities exempt under Section 3 hereof, (ii) purchasers or offerees of securities in transactions exempt under other subsections of this Section 4, and (iii) purchasers or offerees of securities which are part of an offering registered under Section 5 hereof; provided further that (1) no commission, discount or other remuneration exceeding 15% of the initial offering price of the securities is paid or given directly or indirectly for or on account of the sale; (2) the securities shall not be offered or sold by any means of general advertising or general solicitation; and (3) the issuer, controlling person or dealer shall file with the Secretary of State a report of sale not later than 30 days after the sale, setting forth the name and address of the issuer and of the controlling person, if the sale was for the direct or indirect benefit of such person, the total amount of the securities sold under this subsection G, the price at which the securities were sold, the commissions or discounts paid or given, the names and addresses of the purchasers, and a representation that offers to sell such securities were not made to persons in excess of the number permitted by this subsection. The exemption set out in this subsection G shall not be available for the sale of face amount certificate contracts or investment fund shares. The fee for filing the report of sale shall be \$10. (Such report of sale shall be deemed confidential and shall not be disclosed to the public except by order of court or in court proceedings.)

8. *Id.* (filing fee is \$10).

9. *Id.* § 137.13. See *Sanchez v. Walls*, 59 Ill. App. 3d 75, 375 N.E.2d 138 (2d Dist. 1978) (failure to file a report of sale with the Securities Department violates the Illinois Securities Law and allows the purchaser to void the sale). See *infra* notes 16-23 and accompanying text.

10. ILL. REV. STAT. ch. 121½, § 137.4(G) (1979). Section 4G was amended in 1975, and has not been substantively changed since that 1975 version. The 1975 amendment increased the

month period are exempt from registration if the sales are made to not more than thirty-five persons within Illinois, or if the aggregate selling price of the securities does not exceed \$50,000, and offers to sell such securities are not made to more than seventy persons within Illinois during the twelve month period.¹¹ No commission, discount, or other remuneration exceeding fifteen percent of the initial offering price of the securities may be paid or given, directly or indirectly, for or on account of the sale. In addition, the securities may not be offered or sold by any means of general advertising or general solicitation.¹² A final requirement stipulates that the issuer, controlling person, or dealer must file a report of sale with the Secretary of State

number of permitted purchasers to not more than 35 persons, and added an additional exemption for a securities transaction not exceeding an aggregate selling price of \$50,000, and increased the offeree limitation to not more than 70 persons. See Illinois Securities Law of 1953, Pub. Act No. 79-1176, 2 Ill. Laws 3614, 3639 (1975) (codified as amended at ILL. REV. STAT. ch. 121½, §§ 137.1-.70 (1979)) (one of the authors of this Article, Roger G. Fein, was then chairman of the Securities Advisory Committee to the Illinois Secretary of State, and that Committee recommended these amendments and assisted in having them enacted).

In addition to the alternatives to § 4G suggested in this Article, see *infra* notes 56-64 and accompanying text, the authors urge that § 4G should clearly provide that in the event a report of sale is untimely filed as to some sales but timely filed as to other sales which are part of the same offering, if any such sales are to be voidable, only those sales made more than 30 days prior to the date of filing should be subject to rescission.

Neither § 4G nor any other provision of the Illinois Securities Law provides an exemption for the "big ticket" purchaser—an individual purchaser of a large amount of securities. The individual who has the financial means to make a sizeable purchase does not need the protection provided by the Illinois Securities Law because such a purchaser can protect himself. Therefore, it is suggested that investors purchasing a large dollar amount of securities, for example, purchasers of \$25,000 or more of securities, should be excluded from the 35 purchaser limitation. Also, an exemption should be allowed for "fat cats," individuals with an annual gross income in excess of \$100,000 or a net worth in excess of \$1,000,000.

The Illinois Securities Law also should provide an exemption for the sale of a small dollar amount of securities to an unlimited number of purchasers. A fair figure would be between \$100,000 to \$250,000. Such exemption should be conditioned upon no commission or other remuneration being paid on account of such sales. Finally, the legislature should consider an amendment providing that a good faith failure to timely file would not render the exemption unavailable.

11. ILL. REV. STAT. ch. 121½, § 137.4(G) (1979). For a general discussion of the legislative history of the Illinois Securities Laws, see Young, *Comments and Notes on the Securities Law of 1953*, ILL. REV. STAT. ch. 121½ app. at 539 (1976).

Most securities dealers will admit, off the record, that the 70 person offeree limitation is unrealistic in today's world of corporate finance. A dealer often will complete the sale to the permitted 35 purchasers, but as a practical matter, overlook the offeree limitation. It is submitted that the focus should be on the buyers, not the offerees. The prohibition against general advertising or general solicitation should be an adequate limitation on the number of offerees. Therefore, it is suggested that the limitation on the number of offerees be eliminated, or if not eliminated, substantially increased.

12. ILL. REV. STAT. ch. 121½, § 137.4(G) (1979). A solicited sale of an unregistered corporate security is one in which the salesperson actively encourages the purchase or sale of a security by a client. *Home Indem. Co. v. Reynolds & Co.*, 38 Ill. App. 2d 358, 187 N.E.2d 274 (1st Dist. 1963). The prohibition in the Illinois Securities Law against solicited sales of unregistered securities is unqualified; thus, neither knowledge that the security is unregistered

not later than thirty days after the sale.¹³ The report of sale must set forth the name and address of the issuer and of the controlling person if the sale is for the direct or indirect benefit of such controlling person. The report also must include the total amount of the securities sold under section 4G, the price at which the securities were sold, the commissions or discounts paid or given, the names and addresses of the purchasers, and a representation that offers to sell such securities were not made to persons in excess of the number permitted by section 4G.¹⁴

The report of sale is deemed confidential and may not be disclosed to the public except by order of court or in court proceedings.¹⁵ Upon inquiry, the Securities Department will advise whether a report of sale has been filed for a particular sale. An inquiry may lead to an investigation if no filing has been made. Failure to file a report is a *per se* violation of the Illinois Securities Law.¹⁶

Another statutory provision applicable to reporting the sale of small securities offerings is section 13,¹⁷ which provides that every sale of a security made in violation¹⁸ of the provisions of the Illinois Securities Law

nor intent to defraud the purchaser is required. *Martin v. Orvis Bros. & Co.*, 25 Ill. App. 3d 238, 323 N.E.2d 73 (1st Dist. 1974).

It is urged that the provisions against general advertising and general solicitation should be rephrased as a prohibition rather than a condition of the exemption. Then a violation which should subject a violator to public sanctions, would not necessarily expose the seller to an action for rescission. This would appear appropriate because it is not apparent that the mere presence of general advertising or solicitation adversely or materially affects investors.

13. ILL. REV. STAT. ch. 121½, § 137.4(G) (1979).

Under the Illinois Securities Law, a controlling person is defined as:

[A]ny person selling a security, or group of persons acting in concert in the sale of a security, owning beneficially (and in the absence of knowledge, or reasonable grounds for belief, to the contrary, record ownership shall for the purposes hereof be presumed to be beneficial ownership) either (i) 25% or more of the outstanding voting securities of the issuer of such security where no other person owns or controls a greater percentage of such securities, or (ii) such number of outstanding securities of the issuer of such security as would enable such person, or group of persons, to elect a majority of the board of directors or other managing body of such issuer. In case of unincorporated issuers, "controlling person" means any person selling a security, or group of persons acting in concert in the sale of a security, who directly or indirectly controls the activities of the issuer.

ILL. REV. STAT. ch. 121½, § 137.2-4 (1979). *See Gowdy v. Richter*, 20 Ill. App. 3d 514, 314 N.E.2d 549 (1st Dist. 1974) (controlling persons liable for violation of Illinois Securities Laws); *Brown v. Gitlin*, 4 Ill. App. 3d 1040, 283 N.E.2d 115 (1st Dist. 1972) (defendant who owned 50% of a corporation's stock was a controlling person under § 4G). *But see Froehlich v. Matz*, 93 Ill. App. 3d 398, 417 N.E.2d 183 (3d Dist. 1981) (where defendant did not participate in or have knowledge of decision to sell securities, he was not a controlling person).

14. ILL. REV. STAT. ch. 121½, § 137.4(G) (1979).

15. *Id.*

16. *Id.* § 137.12(D). *See infra* note 18.

17. ILL. REV. STAT. ch. 121½, § 137.13 (1979).

18. Under ILL. REV. STAT. ch. 121½, § 137.12(D) (1979), it is a violation of the Act for any person to:

[F]ail to file with the Secretary of State any application, report or document re-

is voidable at the election of the purchaser.¹⁹ If the purchaser elects to void the sale, he must tender the securities purchased to the seller or to the court.²⁰ The rescission of a securities sale normally requires that the business assets be tendered in the same condition as when the transfer of ownership occurred. If a rescission is valid the seller then is liable for the reasonable attorney fees of the purchaser and for the full amount paid plus interest from the date of payment for the securities less any income or other amounts received by the purchaser.²¹

In electing to exercise rescission of a security transaction made in violation of the Illinois Securities Law, the purchaser must be cognizant of three critical section 13 limitations. First, section 13 prohibits the rescission remedy if the seller does not receive notice from the purchaser. The statute requires that the purchaser give notice of rescission to each person from whom recovery is sought within six months after the purchaser acquires knowledge that the sale is voidable.²² Second, the seller may terminate his exposure to a rescission action by making a repurchase offer in accordance with section 13. Section 13 requires the purchaser to accept an offer to repurchase the securities within fifteen days of the receipt of the repurchase offer, otherwise the purchaser's section 13 rights and remedies will be

quired to be filed under the provisions of this Act, of any rule or regulation made by the Secretary of State pursuant to this Act or to fail to comply with the terms of any order of the Secretary of State issued pursuant to Section 11 hereof.

19. ILL. REV. STAT. ch. 121½, § 137.13 (1979). Section 137.13(A) provides, in pertinent part:

[T]he issuer, controlling person, underwriter, dealer or other person by or on behalf of whom said sale was made, and each underwriter, dealer or salesperson who shall have participated or aided in any way in making such sale, and in case such issuer, controlling person, underwriter or dealer is a corporation or unincorporated association or organization, each of its officers and directors . . . who shall have participated or aided in making such sale, shall be jointly and severally liable to such purchaser.

Id. § 137.13(A).

20. *Id.* The fundamental purpose of a tender requirement in rescission actions is to establish that the purchaser can comply with the essential conditions in any decree of rescission. See *Tobey v. NX Corp.*, 25 Ill. App. 3d 205, 323 N.E.2d 30 (1st Dist. 1974). In *Tobey*, a vendee who purchased securities from defendant corporation brought suit in equity to rescind the sale by reason of defendant's failure to file a § 4G report of sale. The court denied equitable relief on the ground that plaintiff did not make a proper tender of the securities back to the corporation. *Id.* at 211, 323 N.E.2d at 36. Even a victim of a securities fraud who, innocently and harmlessly, is unable to tender the security because of resale forfeits the right to obtain relief. *Elden, Litigation Under Illinois Securities Law*, 60 ILL. B.J. 28, 36 (1971).

21. ILL. REV. STAT. ch. 121½, § 137.13(A)(1) (1979). The interest payable is calculated at the rate of interest or dividends stipulated in the securities sold, and if no rate is stipulated, at the legal rate of interest.

22. ILL. REV. STAT. ch. 121½, § 137.13(B) (1979). According to the Illinois Securities Law, although an investor might know facts which should void his security purchase, the six month period for notice to rescind the sale begins to run only when the investor learns that those facts might have legal consequences. *Hidell v. International Diversified Inv.*, 520 F.2d 529 (7th Cir. 1975).

barred.²³ Third, the purchaser must be aware of the statute of limitation for bringing an action to rescind the sale of securities. According to section 13, no action can be brought for relief more than three years after the date of sale.²⁴ A practical analysis of the three year statute of limitation, thus, could give a purchaser a "put" for up to three years from the date of sale if the seller who otherwise fully complied with the provisions of section 4G, and all other provisions of the Illinois Securities Law, merely failed to file a report of sale.

CASE LAW CONCERNING SECTION 4G

Enacted for the protection and benefit of the public as a whole, the Illinois Securities Law is paternalistic in character.²⁵ In view of this paternalistic character, courts have been forced to closely construe section 4G. For example, in *Gowdy v. Richter*,²⁶ defendant seller of unregistered securities argued that strict compliance with section 4G should not be determinative of whether a sale of unregistered securities qualifies under the 4G exemption.²⁷ Defendant specifically contended that the requirement of filing a report of sale was merely a directive and not an obligatory provision. The *Gowdy* court, however, held that strict compliance with the provisions of section 4G was mandatory in ascertaining whether a security was exempt from registration.²⁸ The court reasoned that the statutory language explicitly required filing a report of sale, and therefore, noncompliance with section 4G precluded claiming the statutory exemption.²⁹

To protect against inequitable application of the section 4G report of sale requirement, some courts have provided exceptions to strict application of the statute.³⁰ In *Stevens v. Crystal Lake Transport Sales, Inc.*,³¹ plaintiff corporate president brought an action to rescind his purchase of corporate

23. ILL. REV. STAT. ch. 121½, § 137.13(C) (1979).

24. *Id.* § 137.13(D). The date of final payment and delivery of the securities is the date for computing a sale within the three year statute of limitation period. *Silverman v. Chicago Ramada Inn, Inc.*, 63 Ill. App. 2d 96, 211 N.E.2d 596 (1st Dist. 1965).

25. *See* *Martin v. Orvis Bros. & Co.*, 25 Ill. App. 3d 238, 323 N.E.2d 73 (1st Dist. 1974) (Illinois Securities Law protects the public from unscrupulous and irresponsible persons engaged in security transactions); *Meihnsner v. Runyon*, 23 Ill. App. 2d 446, 163 N.E.2d 236 (2d Dist. 1960) (Illinois Securities Law protects the public from deceit and prevents fraud in security transactions).

26. 20 Ill. App. 3d 514, 314 N.E.2d 549 (1st Dist. 1974).

27. *Id.* at 520, 314 N.E.2d at 557.

28. *Id.* *See* *Brown v. Gitlin*, 4 Ill. App. 3d 1040, 283 N.E.2d 115 (1st Dist. 1972). For a discussion of *Brown*, see *infra* note 59.

29. One court concluded that strict compliance with the 4G report of sale also is necessary to insure comprehensive files of security dealings. *Mark v. McDonnell & Co.*, 447 F.2d 847, 851 (7th Cir. 1971).

30. The Illinois Securities Law is a shield for the innocent and should not serve as a sword for the investor who fails to reap the expected return on his investment. *Burke v. Zipco Oil Co.*, 19 Ill. App. 3d 909, 913, 312 N.E.2d 399, 403 (1st Dist. 1974).

31. 30 Ill. App. 3d 745, 332 N.E.2d 727 (1st Dist. 1975).

stock pursuant to section 13 of the Illinois Securities Law because no filing had been made under section 4G.³² Plaintiff asserted that the shares of stock were not registered with the Secretary of State and were not properly qualified for exemption from the registration requirement. The court, however, refused to allow rescission because the plaintiff, as president of the corporation, had been in charge of the general management of the company and should have ensured that the 4G report of sale was properly filed. The court concluded that a corporate officer who purchased corporate stock issued in violation of the Illinois Securities Law could not rescind the purchase merely because the investment proved unprofitable.³³

As in *Stevens*, the Illinois appellate court again applied an exception to the report of sale provision in *James v. Erlinder Manufacturing Co.*³⁴ In *James*, plaintiff purchased twenty percent of a closely held corporation. After purchasing the stock, plaintiff became actively involved in the management of the corporation as a member of the board of directors, vice president, and assistant secretary of the corporation. When the corporation began to incur financial problems three years later, plaintiff sought rescission of his purchase of stock on the ground that no section 4G report of sale was filed.³⁵ Although the sale to plaintiff was made in violation of section 4G, the court held that plaintiff could not rescind the sale. The court did not deem relevant that the plaintiff was not an officer and director at the time of the purchase but, rather, only became an officer and director after his purchase. The court reasoned that plaintiff was an active participant in the management of the corporation during and after the period in which the sale should have been reported to the Secretary of State. Because plaintiff was an officer of the corporation, the *James* court concluded that it was incumbent upon him to ensure that the section 4G report of sale was properly filed.³⁶

James and *Stevens* indicate that the courts have tried to avoid inequitable results that may occur under section 4G. In both of these cases there was a long time period before rescission was sought. Also, both situations involved plaintiffs who were in a position to bring about the filing of the section 4G report of sale. As the *James* court properly noted, the Illinois Securities Law may not be used to rescind a transaction merely because the investment proves unprofitable.³⁷ If a transaction could be rescinded on this basis, a purchaser who subsequently obtained control of a business and who proceeded to milk the assets of that business could be rewarded for an intentional violation of the Act caused by the failure to file a report of sale.

32. In *Stevens*, plaintiff brought the suit for rescission two and one-half years after the sale of securities because the business had suffered financial reversals. *Id.* at 748, 332 N.E.2d at 729.

33. *Id.* at 748, 332 N.E.2d at 730.

34. 80 Ill. App. 3d 4, 398 N.E.2d 1225 (1st Dist. 1979).

35. *Id.* at 8, 398 N.E.2d at 1227.

36. *Id.*

37. *Id.* at 9, 398 N.E.2d at 1228.

The Illinois Securities Law is not intended, and the courts should not allow the law to protect or aid the business raider.

The Illinois appellate court then faced another difficult question pertaining to unregistered security transactions. In *Condux v. Neldon*,³⁸ defendant, the sole shareholder of a gun shop, sold all his interest in the shop—lock, stock, and barrel—to plaintiffs for \$186,000. Two and one-half years after the sale, plaintiffs became dissatisfied with the business and sought to rescind the sale contending that the transaction was a sale of unregistered securities in violation of the Illinois Securities Law. Although the court referred to section 4G case law, the court chose not to follow the rationale of those cases because the issue of registration was never reached.³⁹ Instead, the court held that the transaction was not a sale of securities and, therefore, was not within the coverage of the Illinois Securities Law. Because the court followed the theory that “form is disregarded for substance and emphasis is placed on economic reality,”⁴⁰ the court reasoned that, in substance, plaintiffs had bought a commercial business and the sale of stock was merely a matter of form. The court applied the passive investor test enunciated in *SEC v. Howey*⁴¹ and held that the transaction did not involve securities because the purchasers did not make their investment in a common enterprise with the expectation to receive profits solely from the efforts of others. Asserting that if plaintiffs prevailed it would result in a windfall for the plaintiffs and a trap for defendants, the *Condux* court concluded that the Illinois Securities Law is not a “shield between the promoter and the sucker, or a sword with which the merely unskillful or unlucky businessman may oppress his predecessors.”⁴²

More recently, the Illinois appellate court has held that *Condux* is not limited exclusively to purchasers of one hundred percent of the stock of a corporation. In *Kaiser v. Olsen*,⁴³ the defendants paid the plaintiffs \$100,000 in return for stock representing approximately two-thirds of the entire stock of the corporation.⁴⁴ The sellers had resigned as officers and directors of the corporation and the purchasers were actively involved in the management of the corporation both before and after the sale.⁴⁵ The *Kaiser*

38. 83 Ill. App. 3d 575, 404 N.E.2d 523 (1st Dist. 1980).

39. *Id.* at 576-77, 404 N.E.2d at 525.

40. *Id.* at 577, 404 N.E.2d at 525 (citing Polikoff v. Levy, 55 Ill. App. 2d 229, 234, 204 N.E.2d 807, 809 (1st Dist. 1965)).

41. 328 U.S. 293 (1946). The *Howey* test requires that for a security to fall within the meaning of federal securities laws, the contract, transaction, or scheme must involve a person who invests money in a common enterprise expecting to receive profits solely from the efforts of others. *Id.* at 301. *Cf.* United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975) (economic reality test for determining security transactions). The economic reality test announced in *Forman* is a reaffirmation of the *Howey* test. The economic reality test inquires whether the investment pertains to a common venture premised on the reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *Id.* at 852.

42. 83 Ill. App. 3d at 585, 404 N.E.2d at 531.

43. 105 Ill. App. 3d 1008, 435 N.E.2d 113 (1st Dist. 1982).

44. *Id.* at 1009-10, 435 N.E.2d at 115.

45. *Id.* at 1010, 435 N.E.2d at 115.

court held that *Condux* was applicable under these facts and, therefore, the transaction was not a sale of securities but rather was the sale of control of a business.⁴⁶ Accordingly, the court concluded that the sale was not within the scope of the Illinois Securities Law.⁴⁷

The *Condux* and *Kaiser* decisions demonstrate that unjust application of the Illinois Securities Law can be prevented. *Condux* and *Kaiser* are welcomed and enlightened opinions, and recently, courts in other jurisdictions have reached similar conclusions.⁴⁸ Although the case law indicates that the courts have assumed the task of preventing inequitable results, the courts should not be faced with such an onerous burden. If a statutory provision is unjust, the statute should be changed. Time should not be expended in the courthouse on something easily remedied by the legislature.

PROBLEMS POSED WITH THE SCHEME OF SECTION 4G

Section 4G is intended to aid small businesses by allowing them to raise capital on a limited basis without incurring the sizeable costs incident to registering a public securities offering.⁴⁹ Small entrepreneurs often start businesses and are unaware of the legal, financial, insurance, and tax consequences inherent in operating a business.⁵⁰ Because of this lack of management knowledge, many small businesses fail within their first years. Accord-

46. *Id.* at 1012-13, 435 N.E.2d at 117-18.

47. *Id.*

48. *See, e.g.,* *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981). In *Frederiksen*, the Seventh Circuit held that the sale of a boat marina in which the purchaser received 100% of the stock as an indicia of ownership was not the sale of securities as envisioned by the federal securities law. In applying the *Forman* economic reality test, *see supra* note 41, the court found that the economic reality of the situation was that the purchaser intended to take complete control of the boat marina. Stating that not all transactions which involve stock are necessarily covered by the securities laws, the court concluded that the transaction did not involve securities because the purchaser assumed complete control of critical corporate decision making. *Id.* at 1148.

See also *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982) (private sale of all of a sole shareholder's corporate stock to purchaser who intended to personally operate and manage the business is not a securities transaction); *Anchor-Darling Indus., Inc. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981) (purchase of a business by a transfer of stock did not involve the sale of a security); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981) (acquisition of a company through the transfer of stock was commercially motivated and did not involve a security investment transaction); *Dueker v. Turner*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. Dec. 28, 1979) (transfer of stock incidental to the sale of a business did not transform the sale into a securities transaction). *But see* *Golden v. Garafalo*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,656 (2d Cir. May 5, 1982) (sale of 100% of the stock in a ticket brokerage business in connection with the transfer of business ownership was the sale of a security).

49. All securities, except those exempt under specific sections, shall be registered prior to sale. General registration information consists of the name and address of the registrant, the prospectus, information not required in the prospectus, and exhibits. ILL. REV. STAT. ch. 121½, § 137.5 (1979).

50. OFFICE OF BUSINESS SERV., ILL. DEP'T OF COMMERCE AND COMMUNITY AFFAIRS, STARTING A SMALL BUSINESS (1981).

ingly there is a high risk associated with starting a small business. As a result, start up capital for small business is scarce.⁵¹

Because the 4G exemption is intended to aid small businesses in their capital raising efforts, it is more common to find a small business person than a registered dealer involved in a 4G transaction. A small business person, unalert to the consequences of a delayed filing of the 4G report, may carefully comply with all of the 4G requirements, yet fail to qualify for the registration exemption because of some imperfection in the filing of the 4G report of sale. An innocent and innocuous defect of this type could have harsh and inequitable consequences.⁵²

Moreover, a failure to meet the requirements for the exemption may occur simply because the report is filed late. A late filing could occur in light of the very brief filing period and the relative insignificance of the report in comparison to the substantive elements of the exemption. It would be easy to set the report aside pending completion of more important tasks and then discover that the filing period had lapsed. Furthermore, the report may be filed late due to causes outside the control of the filing person, such as a delay in postmarking. The brief filing period does not take inadvertent delays into account.

In view of the special financing needs of small businesses, an adequate market to raise capital must exist. The Governor's Task Force on the Future of Illinois delivered a report in 1980 which analyzed the State of Illinois' relation with small businesses.⁵³ To attract needed private investment, the report concluded that steps should be taken to eliminate excess regulation of economic activity.⁵⁴ In addition to the Governor's Task Force, a substantial segment of the business community is also seeking less regulation of small businesses. Aware of the special needs of small businesses, the General Assembly of the State of Illinois recently enacted legislation that provides for the flexible application of state agency rules and regulations to small businesses.⁵⁵

Section 4G, arguably, constitutes overregulation of small business, increases the cost of doing business in Illinois, and decreases the stability of

51. *Id.*

52. *See supra* notes 25-48 and accompanying text.

53. TASK FORCE ON THE FUTURE OF ILLINOIS, ILLINOIS: THE FUTURE (1980).

54. *Id.*

55. State Agency Rules and Regulations—Flexible Application to Small Businesses, Pub. Act. No. 82-492, 1981 Ill. Legis. Serv. 2215-18 (West) (to be codified at ILL. REV. STAT. ch. 127, §§ 1003.10, 1004.03, 1005.01). In enacting the provision, the General Assembly declared:

- (1) That small business has been subjected to unnecessary burdens and costs to comply with rules which have been adopted by state agencies;
- (2) That the objectives of many of the laws enacted by the General Assembly can be accomplished through rules by state agencies which include flexible provisions relating to compliance by small businesses; and
- (3) That the special needs and problems of small businesses should be recognized and considered by state agencies in relation to the procedures utilized in rulemaking and the requirements imposed by rules.

Id.

transactions because of the possibility of rescission actions. Many small businesses raise needed capital in an informal manner without benefit of counsel or upon advice of counsel inexperienced in securities laws. Consequently, many small business persons mistakenly believe that securities laws only apply to large corporations whose securities are listed on stock exchanges. The small business person may be unaware of the section 4G report of sale requirement, may fail to file the report, and therefore, may be ineligible for the small offering exemption. To benefit small businesses, the small offering exemption should be available regardless of whether small business persons are aware of the report of sale requirement.

ALTERNATIVES TO SECTION 4G

The report of sale is inherently burdensome on small businesses and restricts their ability to issue securities. The Illinois General Assembly should examine measures to alleviate the difficulties created by this provision. Several viable alternatives to the 4G filing requirement include: elimination of the filing requirement, adopting legislation similar to Kentucky's securities regulations,⁵⁶ requiring that only registered securities dealers be subjected to the report of sale filing provision,⁵⁷ or permitting a limited exception to the filing requirement.⁵⁸ An overview of these proposals evinces that legislative modification of section 4G will enhance the ability of small businesses to raise capital by issuing securities.

Of course, the best alternative would be to eliminate the section 4G filing requirement. In so doing, any and all inequitable results would be avoided.⁵⁹ Generally, when a sale under section 4G occurs, both purchaser and seller are fully aware of the circumstances surrounding the sale. To give the purchaser an out merely because of the failure to file an unimportant piece of paper,⁶⁰ provides the purchaser with an undue advantage over the

56. KY. REV. STAT. § 292.410(1) (1978). See *infra* notes 62-63 and accompanying text.

57. Although applying the report of sale provision to only registered dealers may appear discriminatory, the distinction is based upon a logical rationale. See *infra* notes 72-73 and accompanying text. Often statutes regulating securities law exemptions are, in effect, a form of discrimination; however, courts usually uphold such provisions if the classifications are reasonable. *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).

58. See *infra* note 74 and accompanying text.

59. See *Brown v. Gitlin*, 4 Ill. App. 3d 1040, 283 N.E.2d 115 (1st Dist. 1972). *Brown* involved the purchase of 50% of the outstanding shares of stock by a shareholder, officer, and director who already owned 50% of the stock. In *Brown*, defendant was the controlling person of the corporation who was required to report the sale of securities to the Secretary of State. Defendant, owner of the stock sold to *Brown*, failed to file a report of sale within the 30 day period following the sale. The court held the sale of securities to be void because of defendant's failure to file a report of sale. *Id.* See *supra* notes 25-48 and accompanying text.

60. Cf. 44 U.S.C. § 3501 (Supp. IV 1980). Section 3501, the Paperwork Reduction Act of 1980, was enacted to reduce paperwork and enhance the economy and efficiency of the government. This act provides, in pertinent part:

The purpose of this chapter is—

- (1) to minimize the Federal paperwork burden for individuals, small businesses, state and local governments, and other persons. . . .

seller. By eliminating the filing requirement both buyer and seller would be placed on equal terms.⁶¹

A second possible alternative to section 4G would be to enact legislation similar to Kentucky's limited offering exemption.⁶² The Kentucky statute provides the state's director of securities with authority to withdraw or further condition exemptions.⁶³ In Kentucky, failure to satisfy securities law exemption requirements does not automatically give rise to a private right

61. In 1975, the legislature eliminated the report of sale in certain circumstances when it enacted § 4(O) as recommended by the Securities Advisory Committee to the Illinois Secretary of State. ILL. REV. STAT. ch. 121½, § 137.4(O) (1979). Section 4(O) exempts the sale of securities (other than fractional undivided interests in an oil, gas, or other mineral lease, right, or royalty) if the securities sold, immediately following the sale(s), together with securities already owned by the purchaser, constitute 50% or more of the equity interest of any one issuer, provided the number of purchasers is not more than five and no commission, discount, or other remuneration exceeding 15% of the aggregate sale price is paid or given. Section 4(O) does not require the filing of a report of sale. *Id.* Prior to the enactment of § 4(O), the purchase of the equity interest of a small "ma and pa type business" could be voided if the report of sale under § 4G was not timely filed.

62. See KY. REV. STAT. § 292.410 (1978). The Kentucky exempt transaction statute provides that certain small offering securities transactions will be exempt from registration requirements. A sale to not more than 25 persons during any period of 12 consecutive months will be exempt if the seller reasonably believes that all the buyers are purchasing for investment and no remuneration is paid to any prospective buyer. The Kentucky statute further provides that:

[T]he director may by rule or order, as to any security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in subparagraphs 1. or 2. of this paragraph with or without the substitution of a limitation or remuneration.

Id. § 292.410(1)(i). For an analysis of the Kentucky Blue Sky Law, see generally Comment, *Recent Changes in Kentucky Securities Law*, 61 KY. L.J. 1003 (1973) [hereinafter cited as *Recent Changes*].

63. The Kentucky statute specifically delineates the director's authority to review exempt securities transactions. The statute provides:

The director may by order deny or revoke the exemption . . . with respect to a specific security or transaction. No such order may be entered without appropriate prior notice to all interested parties, opportunity for hearing, and written findings of fact and conclusions of law, except that the director may by order summarily deny or revoke any of the specified exemptions pending final determination of any proceeding under this subsection. Upon entry of a summary order, the director shall promptly notify all interested parties that it has been entered and of the reasons therefor and that within fifteen (15) days of the receipt of a written request the matter will be set down for hearing. If no hearing is requested and none is ordered by the director, the order will remain in effect until it is modified or vacated by the director. If a hearing is requested or ordered, the director, after notice of and opportunity for hearing to all interested persons, may modify or vacate the order to extend it until final determination. No order under this subsection may operate retroactively. No person may be considered to have violated this chapter by reason of any offer or sale effected after the entry of an order under this subsection if he sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known of the order. In any proceeding under this chapter, the burden of proving an exemption from a definition is upon the person claiming it.

KY. REV. STAT. § 292.410(2) (1978).

of action. Instead, the director has authority to review any allegations of noncompliance and to determine whether to deny an exemption or rescind a specific exempt transaction.⁶⁴ The director's authority to deny exemptions or revoke transactions is purely discretionary.⁶⁵ The party requesting the director's review must submit a request for a ruling and a verified statement of material facts relating to the transaction.⁶⁶ After notice is given to the interested parties, and a hearing is conducted, the director may enter an order relating to the transaction.⁶⁷ Any order the director enters is binding unless an appeal is taken.⁶⁸

The advantage to Illinois in adopting the Kentucky rule is that failure to file the report of sale would not be a per se violation of the securities laws.⁶⁹ Following Kentucky, the Illinois legislature could statutorily grant the securities commissioner the power of discretionary review of an alleged failure to file the report of sale. Such a provision would place a preliminary check upon actions for rescission based upon failure to file the 4G report.⁷⁰ To facilitate this preliminary review, the Illinois Securities Law specifically should require that a verified statement of all material facts relating to the transaction be submitted with the request to review. This pertinent information would supply the commissioner with investigatory material necessary for a just determination on the issue of rescission.⁷¹ Parties who are in substantial compliance with the significant provisions of the exemption should be able to establish the exemption notwithstanding some minor defect under its provisions.

64. *Id.*

65. *Id.* See *Recent Changes*, *supra* note 62, at 1010.

66. KY. REV. STAT. § 292.420(3) (1978). See *Recent Changes*, *supra* note 62, at 1010. In Kentucky, the burden of proving an exemption is placed upon the person claiming the exemption. KY. REV. STAT. § 292.420(2) (1978). Furthermore, if the director believes the information is "misleading, incorrect, inadequate, or fails to establish the right of exemption," the director may require the person claiming the exemption to provide the additional information necessary to rule on the claimed exemption. *Id.* § 292.420(2).

67. KY. REV. STAT. § 292.420(3) (1978).

68. *Id.* See, e.g., *Allstate Indus. Loan Plan, Inc. v. Mihalek*, 555 S.W.2d 585 (Ky. 1977) (industrial loan corporation sought review of an order of the director requiring it to register certificates of investment before selling securities); *Scholarship Counselors, Inc. v. Waddle*, 507 S.W.2d 138 (Ky. Ct. App. 1974) (appeal taken from a final order which affirmed the director's restriction of the offer or sale of a certain scholarship plan or program).

69. Pursuant to § 12 of the Illinois Securities Law, failure to file any report required under the provisions of the Illinois Securities Law is a per se violation of the Act. ILL. REV. STAT. ch. 121½, § 137.12(D) (1979). See, *Sanchez v. Walls*, 59 Ill. App. 3d 75, 375 N.E.2d 138 (2d Dist. 1978).

70. Section 13 of the Illinois Securities Law provides that every sale of a security made in violation of the Act shall be voidable only at the election of the purchaser. ILL. REV. STAT. ch. 121½, § 137.13(A) (1979).

71. The information obtained from the 4G report of sale does not provide substantial facts to make an informed determination of the propriety of an investigation. *Cf. Dixon v. O'Connor*, 94 Ill. App. 3d 656, 419 N.E.2d 83 (4th Dist. 1981) (the Secretary of State is unable to make an informed determination of the necessity of each securities investigation; therefore, the secretary has the authority to delegate the power to make such a determination).

Another possible alternative is to impose the section 4G filing requirement only upon sales made through registered securities dealers. Securities dealers are individuals who engage in offering, selling, buying, or otherwise trading in securities.⁷² In Illinois, to ascertain whether a registered dealer has sufficient knowledge of the securities laws, the registration provision requires a dealer to pass the Securities Dealer Examination.⁷³ Knowledge of the Illinois Securities Law, therefore, may be legitimately imputed upon registered securities dealers. In applying the 4G filing requirement only to registered dealers, the provision would not be an obstacle for small offering transactions by parties who have limited exposure to the securities laws, and the report of sale would not be a trap for those unaware of the filing requirement.

A final alternative would be to modify section 4G to provide a limited exemption to the filing requirement.⁷⁴ Under this approach the issuer would

72. According to the Illinois Securities Law, a "dealer" refers to:

[A]ny person, other than a salesperson, or controlling person and other than a bank organized under the banking laws of this State or of the United States or other than a trust company organized under the laws of this State, who engages in this State, either for all or part of his or her time, directly or indirectly, as agent, broker or principal, in the business of offering, selling, buying and selling, or otherwise dealing or trading in securities issued by another person.

ILL. REV. STAT. ch. 121½, § 137.2-7 (1979). Compare *Martin v. Orvis Bros. & Co.*, 25 Ill. App. 3d 238, 323 N.E.2d 73 (1st Dist. 1974) (plaintiff registered securities dealer who purchased securities for his own account was not a "dealer" as contemplated by the Illinois Securities Law) with *Reid v. NX Corp.*, 11 Ill. App. 3d 706, 297 N.E.2d 380 (1st Dist. 1973) (stock purchaser in the business of dealing in short-term negotiable instruments was a "dealer" within the ambit of the Illinois Securities Law). For a general discussion of securities dealers, see *Burns & Haskin, Illinois Law Relating to Securities Dealers, Salesmen, and Investment Advisors*, 1961 U. ILL. L.F. 240.

73. A dealer registered under Illinois law is required to take a registration examination. According to § 137.8(B) of the Illinois Securities Law:

The Secretary of State shall provide and conduct an examination, to be known as the Securities Dealer Examination, which may be written or oral, or both, for the purpose of determining whether an applicant has sufficient knowledge of the securities business and laws relating thereto to act as a registered dealer.

ILL. REV. STAT. ch. 121½, § 137.8(B) (1979). Section 8 further provides that any person who has continued to remain registered and has previously passed the Securities Dealer Examination, or an examination designated as equivalent, is not required to retake the examination to be a registered dealer. *Id.*

74. This alternative would be modeled under former Rule 240, promulgated pursuant to the Federal Securities Act of 1933. 17 C.F.R. § 230.240 (1980) (rescinded by SEC Release No. 6389 (March 8, 1982)). Rule 240 provided that instead of registering a security, the issuer was required to file a notice of sale with the Regional Office of the Securities & Exchange Commission where the issuer's principal business operations were conducted. 17 C.F.R. § 230.240(h) (1) (1980). Rule 240, nevertheless, permitted a limited exception to the filing requirement. Although the issuer was instructed to file a notice of sale, the exemption for the first \$100,000 raised was not conditioned upon this filing directive. *Id.* § 230.240(h)(2). This exception from the filing requirement, however, was limited in that it was unavailable for subsequent exemptions under Rule 240, unless the issuer filed the notice.

Rule 240 was rescinded and replaced by Rule 504 promulgated pursuant to the Federal Securities Act of 1933. 17 C.F.R. § 230.504 (adopting SEC Release No. 6389 (Mar. 8, 1982)).

be instructed to file a notice of sale. An exemption from this requirement to file a notice could be established for the first \$100,000 of securities sold. This exemption from the filing requirement could be limited in that it would be unavailable for subsequent use of section 4G unless the issuer "cures" the earlier failure to file a notice. Such a modification of section 4G would encourage both the growth of existing small businesses and the establishment of new businesses. The requirement that the exemption would be unavailable for subsequent sales unless the seller cured the prior lack of filing would ensure that once the aggregate allowable amount of securities was exceeded, the notice would have to be filed. Although encouraging the growth of small businesses, this narrow exception would prohibit the exemption once the offering exceeded certain statutory limitations.

CONCLUSION

Illinois should make it easier for small businesses to raise capital. The elimination or modification of the section 4G report of sale is in the public interest and consistent with the goal of protecting investors. Most attorneys, the securities industry, and especially small businesses will welcome such changes. To permit an experienced and knowledgeable investor, fully apprised of the risks of an investment, to rescind up to three years after the investment because of the failure to file an inconsequential report of sale appears to be an extreme sanction absent any misrepresentation by the seller. The unnecessarily harsh consequences and arbitrary operation of the section 4G report of sale should be changed by legislative action to ensure greater equity in the application of the Illinois Securities Law.

Rule 504 is part of Regulation D which contains limited offering exemptions that rescind limited offering exemptions under Rules 146, 240 and 242. *Id.* Rule 504 raises the aggregate offering price limitation from \$100,000 to \$500,000, but discontinues the exemption from filing a notice for the first \$100,000 of securities sold. In addition, the provisions of Rule 240 limiting sales to 100 investors have been dropped in Rule 504. Instead, Rule 504 permits sales to an unlimited number of investors. The SEC has properly shown its understanding of the number of investors and size of securities offerings necessary for small businesses to raise capital in today's financial marketplace. Illinois should follow the lead of its federal counterpart.

Although Rule 504 does not continue the Rule 240 exemption from filing a notice for the first \$100,000 of securities sold, it should be noted that the Securities and Exchange Commission specifically stated that it desired to have one uniform notice of sale for limited offering exemptions under both Regulation D and § 4(6) of the Federal Securities Act of 1933. SEC Release No. 6389 (March 8, 1982); SEC Release No. 6339 (August 7, 1981). See Coles, *Regulation D—New Rules for Raising Capital in Non-Public Financing*, 70 ILL. B.J. 612 (1982). The SEC, however, realized that the notice requirement would impose an undue burden on offerings below \$100,000. SEC Release No. 6339 (August 7, 1981). Accordingly, it appears that the SEC removed the old Rule 240 exemption from filing a notice for the first \$100,000 of securities sold because it wanted a uniform notice of sale form to be used in limited offering exemptions, the permitted number of investors was raised from 100 investors to an unlimited number and the maximum size of the offering exemption was increased from \$100,000 to \$500,000.

