Securities Lawyers: Beware of Clarity

By Michael H. Friedman and Joshua Ashley Klayman

From their very first law school classes, lawyers are taught to research and rely upon precedent when determining how to interpret a given law. Litigators learn early that a statute is given its meaning by the cases that test it, not just by the treatises that explain the statute's rationale or the legislative history that accompanied its adoption.

For securities lawyers, precedent appears in the form of prior debt and equity financings, mergers, tender offers and other capital markets transactions. Another source of precedent is found in transaction-based guidance provided by the US Securities and Exchange Commission (the SEC), as well as by the rules and regulations promulgated thereby. The "precedent" transactions and SEC interpretations that guide securities lawyers ultimately may not serve as binding precedent in court if litigation ensues. Nonetheless, it is understandable that securities lawyers look to "peer" transactions and SEC guidance when reaching a judgment that a particular transaction complies with securities laws.

One challenge when assessing securities law compliance is that, despite similarities or "resemblances" among capital markets transactions, most transactions include features, or reflect circumstances, that could differentiate significantly any one from the others. Perhaps, for example, in one transaction, the issuer is a "well known seasoned issuer," whereas in another seemingly similar transaction, the issuer only recently completed its initial public offering. Or, maybe, in one transaction, an operating subsidiary issues unsecured debt without a parent guaranty, while in another transaction, an operating subsidiary issues unsecured debt that is guaranteed by the parent.

In the absence of SEC guidance that is directly on-point, how is a securities lawyer to know whether and when such "transaction differentiators" change the result, or matter at all? How can a securities lawyer first identify those transaction features that make a difference and which, if not addressed, would expose a transaction to challenge from the SEC or an aggrieved stockholder?

Securities lawyers are faced with these difficult questions every day. It is no simple or easy task to research and analyze every recent "precedent" transaction, let alone to consider all of the nuances thereof. For that reason, when the SEC has spoken on a given topic, it is tempting to rely on the SEC's clear words as authority when assessing legal compliance. Even when the SEC has addressed a particular issue, when counseling clients, corporate practitioners must be careful to identify the limits on inferences that can be drawn from such SEC guidance and to learn to recognize transaction aspects that can alter the compliance analysis.

The SEC's Division of Corporation Finance (the Division) typically provides guidance, in the form of no-action letters and interpretive advice that is limited in scope to the facts presented to the Division. Moreover, the Division specifies that the guidance provided in the no-action letters is to be relied upon only by the addressee of the no-action letter and not by other parties, and the Division often in the no-action letters states that the Division expresses no opinion as to the merits of the analysis provided by the party that submitted the no-action letter. In this way, even the Division's clearest explanations often are narrow in scope and do not address all of the transaction variables or provide an overarching framework that is generalizable to other potentially analogous transactions. Identifying relevant "transaction differentiators" requires a close textual reading of applicable rules and regulatory interpretations, but attention to detail is not enough. Imagination and expanding the scope of one's analysis beyond the written words also is required.

Consider the Division's Compliance and Disclosure Interpretations, Securities Act Section (November 26, 2008 Update) (the CDI). The CDI uses a straight-forward "question and answer" format, with the intention to simplify and address head-on many recurring issues encountered by securities lawyers. Each presented scenario, and the

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accompanying answer, is concise, fact-light, and, on its face, clear. Indeed, the brevity of each "Q&A" is enticing, for it seems to indicate that the guidance provided by such "Q&A" may be applied to a variety of transactions.

Because the questions posed are drawn from actual transactions, however, it is challenging for one to discern, or divine, the SEC's rationale that underlies each scenario. Without a comprehensive framework or decision tree that maps the SEC's analysis, it is unclear how much, and in what ways, each proposed transaction can be modified before the Division's guidance no longer applies. One cannot be certain in what circumstances one must look beyond the text of each "Q&A," and real transactions, unlike those appearing in the CDI, are fact-intensive. In that way, the clarity provided by the CDI may be deceptive. Corporate practitioners are well advised to consider SEC guidance, such as the CDI, not as containing the answer as to whether a transaction complies with securities laws, but, instead, as the baseline for their analysis and as one component of the applicable precedent.

Consider Q&A 103.01 of the CDI, addressing Securities Act Section 2(a)(3) to illustrate this proposition, which states:

> "**Question:** If a company declares a dividend that is payable in either cash or securities at the election of the recipients, does the declaration of the dividend need to be registered under the Securities Act?
>
> **Answer:** No, as there is no sale of the dividend shares under the Securities Act. [Nov. 26, 2008]"

If a client calls his or her corporate and securities counsel, explaining that the client wishes to declare a dividend that is payable in either cash or securities at the election of the recipients and asking whether the client needs to register such declaration under the Securities Act, based solely on Q&A 103.01, counsel might advise such client that, no, registration is not necessary, because there has been no sale of securities.

If the same client inquires as to why registration is not required, when the cash that is paid pursuant to the dividend could be used to purchase new shares, the counsel might conduct additional research and identify SEC Release No. 33-929. SEC Release No. 33-929 states a conclusion that appears to hinge on the absence of "consideration" or (to use the terminology in Section 2(a)(3) of the Securities Act) "value." Accordingly, counsel might advise the client that registration of the cash-stock dividend is unnecessary because, on the client's facts, the stockholders are giving no consideration or value in exchange for the dividend shares. Counsel might explain to the client that the concept of consideration is broad and includes not only the giving of money but also, for example, the forbearance of a vested right to do or receive something.

The client, or counsel, then poses a follow-up question: If the absence of consideration and the logic set forth in SEC Release No. 33-929 underlies the Division's rationale in Q&A 103.01 in determining what constitutes a sale, then why is a Section 3(a)(9) registration exemption available in the scenario described by Q&A 125.04? Q&A 125.04 asserts that a Section 3(a)(9) registration exemption is available for the conversion of preferred stock into common stock, even where a condition of such conversion is the waiver by the preferred stockholders of accrued but unpaid dividends on the preferred stock.

The final paragraph of SEC Release No. 33-929, states, in pertinent part,

> "….upon the public declaration of a cash dividend out of surplus, the holders of the stock in respect of which the dividend is declared acquire immediately the rights of creditors of the corporation, and cannot be divested of these rights by subsequent action of the board of directors. If, therefore, there is declared a cash dividend payable to all stockholders, and if the board thereafter determines to grant to stockholders the opportunity to waive their pre-existing and vested right to payment of the dividend in cash, and to receive the dividend in the form of securities, the stockholders electing to take securities would in my opinion be regarded as giving value for the securities so received."

Based on SEC Release No. 33-929, one might have thought that the preferred stockholder described in Q&A 125.04 would have been in the position of a creditor of the corporation and that the waiver by such preferred stockholder of the accrued but unpaid dividends owed by the corporation to such stockholder would constitute the giving by such stockholder of consideration or "value."

Section 3(a)(9) of the Securities Act provides the following exemption from registration:

"Except with respect to a security exchanged in a case under title 11 of the United States Code, any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange;"

If, in Q&A 103.01, there was no sale because no consideration was given by the stockholder, then why doesn't the waiver of a vested right to receive dividends constitute consideration (or, to use the language of Section 3(a)(9) "remuneration"), and, if it does, then how is one to explain this unanticipated result?

Read narrowly, Section 3(a)(9) would seem to posit that a security that is exchanged by a corporation with its existing stockholders is exempt from registration under the Securities Act, provided that no additional consideration is given for such exchanged security. If that is Section 3(a)(9)'s proper interpretation, then, in Q&A 125.04, it would appear that a condition to the Section 3(a)(9) exemption would not be met, because the waiver by the preferred stockholders of accrued but unpaid dividends on the preferred stock would have constituted additional consideration or "value" for the exchanged security. Accordingly, because the Division has indicated in that the Section 3(a)(9) exemption is available in the scenario described in Q&A 125.04, does that mean that the words "no commission or other remuneration" do not include "value" that is derived from and attributable to an exchanged security (*e.g.*, the accrued and unpaid dividends), or, instead, does the Division's answer indicate that Section 3(a)(9) should be construed even more broadly?

Finally, suppose that the client contacts counsel later in the week, explaining that the client now would like to declare a dividend that is payable in cash or securities, at the stockholders' election, and wants to pro-rate the cash component if the aggregate amount of cash that the stockholders elect to receive exceeds a certain, predetermined threshold. Counsel might analyze the scenario under Q&A 103.01 and SEC Release No. 33-929 and determine that there still is no sale because the stockholders gave no value, and advise the client that registration of the election feature is unnecessary. Counsel would not be incorrect in his or her determination that the text of Q&A 103.01 is clear and unambiguous. The plain meaning of such Q&A seems to suggest that, absent a sale of securities, no registration is required.

Interestingly, issuers declaring cash-stock dividends that include formulaic proration features have registered such election features. The CDI, however, makes no mention of such "precedent" registrations. In the presence of seemingly on-point SEC interpretations and guidance, how does a securities lawyer infer the need to look beyond the four corners of the CDI? In the case of registration for cash-stock dividends with proration features, by what rationale would a securities lawyer counsel a client to register the election feature?

Securities lawyers are responsible for determining the correct answer. Identifying relevant "transaction differentiators" requires a close textual reading of applicable rules and regulatory interpretations and a mindset conditioned to asking "*what if*."

Note what is *not* said in Q&A 103.01. For instance, there is no identification of whether the issuer is a "well known seasoned issuer"; indeed, there is no description of the issuer at all. There is no indication of whether the cash component of the cash-stock dividend includes a proration feature, nor is there any information concerning the magnitude of the dividend. For that reason, it is tempting to assume that Q&A 103.01 is generalizable across a multitude of issuers and across any number of cash-stock dividend transactions. In reality, this and other Q&As could be narrow in application and apply only to transactions where there are no "added characteristics," such as proration features, or the answer may be somewhere in between.

It may be and often is difficult to determine at which point one reaches the end of a particular inquiry. Just as one researches case law in a contract dispute, however, one must carefully research recent "peer" transactions and filings and keep abreast of corporate governance periodicals and trends. As the scenario presented above demonstrates, the CDI should be viewed as a starting point, not necessarily the final answer. The final step may vary depending upon the proposed transaction and may include requesting from the Division a no-action letter.

"Precedent" transactions may supplement, lead, and shape the law and potentially could result in new Division guidance. The Division's rationale may not always be comprehensive and forward-looking, and, due to developments of new "transaction features," laws, and other shifts, may not be consistent over time. There may be important, yet unstated and even unconsidered, transaction features that would change the SEC's answer. At what point can a securities lawyer be confident in counseling a client that a proposed scenario complies with securities laws? There is no easy answer, except that as securities lawyers, you must be vigilant. Beware of the easy answers that you find. Beware of "clarity."