Rule 144's Impact on Shell Companies:
One Year Later

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For shareholders of companies that are, or ever were, shell companies, and which are not currently Exchange Act reporting companies, the amendments to Rule 144 in February 2008 have been devastating. Could a change be forthcoming?

Introduction

Almost one year ago, the Securities and Exchange Commission (the "SEC") amended Rule 144 of the Securities Act of 1933 ("Rule 144"), to, among other things, shorten the holding periods necessary to use this resale exemption for issuers that are subject to the Securities Exchange Act of 1934 (the "Exchange Act"). However, as many companies and shareholders have discovered, the revisions to the holding periods only tell part of the story regarding the impact of the amendments to Rule 144. For shareholders of companies that are or ever were shell companies, and that are not currently reporting companies under the Exchange Act, the impact has been that they are not eligible to utilize Rule 144 as a resale exemption to remove the restrictions from their shares in order to sell them in the public market. While not as publicized as the changes to the holding periods, this result for many shareholders of smaller companies has proven to have a much larger impact. Is there any change in sight? Possibly, but probably not in the near future.

History of Rule 144

While the purpose of this article is not to recite the history of Rule 144, a brief review will help in analyzing the February 2008 amendments and how they relate to shell companies.

The Securities Act of 1933 (the "Securities Act") requires all offers and sales of securities in interstate commerce to be either registered or have a valid exemption from registration. Rule 144 under the Securities Act creates a safe harbor for the sale of securities under the exemption provided for in Section 4(1) of the Securities Act. Section 4(1) provides an exemption for transactions by any person other than an issuer (the company), underwriter or dealer. Historically, Rule 144 has treated shares held by affiliates and non-affiliates different in terms of the amount of time each must hold the shares prior to qualifying to use Rule 144, whether the issuer was a reporting or non-reporting company (one year for reporting companies and two years for non-reporting companies) and certain volume limitations.

Historically, the use of Rule 144's exemption by shareholders of shell companies has been a topic of debate. On January 21, 2000, Richard Wulff of the SEC wrote a letter to Ken Worm of the NASD (the "Worm-Wulff Letters") advising that the exemption provided by Rule 144 was not available to "blank check" companies, or companies that were previously "blank check" companies (a "blank check" company is "a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company…."). At the time of the Worm-Wulff Letters there was no definition of "shell company," and, therefore, the Worm-Wulff Letters did not directly address shell companies. The question as to whether Rule 144 was historically available to shareholders of shell companies that were not "blank check" companies (i.e. companies that did not have operations or assets, but had a business plan for specific operations other than to just merge with or acquire an unidentified company) was never answered and the securities law community split on this issue, with some permitting shareholders of shell companies that were not "blank check" companies to utilize Rule 144, and the others holding to the belief that the restrictions in the Worm-Wulff Letters applied equally to "blank check" companies and shell companies.

Rule 144 Amendments

Effective February 15, 2008, the SEC amended Rule 144. These amendments have been discussed in detail over the past year; but in a nutshell, affiliate shareholders are subject to the following in order to utilize Rule 144: (i) six month holding period if the shares are held in an Exchange Act reporting company, one year for a non-reporting company, (ii) the company must have current public information, (iii) volume limitations, and (iv) filing of a Form 144. For non-affiliate shareholders, they are subject to the following in order the utilize Rule 144 as a resale exemption: (i) six month holding period if the shares are held in an Exchange Act reporting company, one year for a non-reporting company, and (ii) if the shares are shares of an Exchange Act reporting company and the shareholder is attempting to sell after six months and less than one year, then the company must have current public information.

Additionally, under the amendments to Rule 144, the Rule is not available for the resale of securities initially issued by "(i) An issuer …. that has "(A) no or nominal operations; and (B) Either: (1) no or nominal operations; (2) assets consisting solely of cash and cash equivalents; or (3) assets consisting of any amount of cash and cash equivalents and nominal other assets; or (ii) an issuer that has been at any time previously an issuer described [above]." See Rule 144(i)(1).

However, an issuer can "cure" its shell status by meeting the following requirements:

(1) is no longer a shell company as defined in Rule 144(i)(1);
(2) has filed all reports (other than Form 8-K reports) required under the Exchange Act for the preceding 12 months (or for a shorter period that the issuer was required to file such reports and materials); and
(3) has filed current "Form 10 information" with the Commission reflecting its status as an entity that is no longer an issuer described in Rule 144(i)(1), and at least one year has elapsed since the issuer filed that information with the Commission.

See Rule 144(i)(2).

The Effect of Rule 144(i) on Shell Companies

Under the revised Rule 144(i), no shareholder can utilize Rule 144 as an exemption from registration if the issuer is, or ever was, a shell company unless the issuer has met the requirements to cure its shell status under Rule 144(i)(2), as outlined above. However, for good reason, the debate did not end with the publishing of the amendments to the rule. The primary cause for debate was the use of the word "initially" in Rule 144(i)(1) and footnote no. 172 to SEC Release No. 33-8869, which is the release that accompanied the final amendments to Rule 144.

Rule 144(i)(1) uses the word "initially" when stating "[t]his section is not available for the resale of securities initially issued by an issuer defined below…" (emphasis added), followed by defining the prohibited issuers in subsections (i) and (ii). Since the final Rule prohibits shareholders of any company that is, or ever was, a shell unless the company has cured its shell status by complying with Rule 144(i)(2), what purpose is the word "initially"? The final rule could have just stated that any shares of companies that are, or ever were, shell companies that have not cured under Rule 144(i)(2), cannot be sold pursuant to Rule 144. The final rule already prohibits the use of Rule 144 by any shareholders of companies that are, or ever were, a shell (unless they have followed Rule 144(i)(2)) without regard as to when the shares were issued by the company or whether they were issued by the company to the shareholder directly or the shareholder acquired the shares from another shareholder. Presumably the word "initially" has some meaning, such as were the shares initially issued by the company at the time the company was a shell, and if they were then Rule 144 cannot be used unless the company has complied with Rule 144(i)(2). However, if the company was not a shell when the shares were initially issued shouldn't a different result apply? Unfortunately, the language of Rule 144(i)(1)(ii) is so broad, "an issuer that has been at any time previously [a shell]" that it takes away any meaning of the word "initially," which was likely not what was intended.

Additionally, at the time of the release of the final Rule 144 amendments, the SEC Release announcing the amendments to Rule 144 appeared to leave the door open for shares that were issued at a time when the company was not a shell company. SEC Release No. 33-8869, contains footnote no. 172, which states:

> Rule 144(i) does not prohibit the resale of securities under Rule 144 that were not initially issued by a reporting or non-reporting shell company or an issuer that has been at any time previously such a company, even when the issuer is a reporting or non-reporting shell company at the time of sale. Contrary to commenters' concerns, Rule 144(i)(1)(i) is not intended to capture a "startup company," or, in other words, a company with a limited operating history, in the definition of a reporting or non-reporting shell company, as we believe such a company does not meet the condition of having "no or nominal operations."

We believe this footnote was intended to clarify the situations when Rule 144(i) would not be applicable. Specifically, Rule 144(i) would not prohibit the resale of securities if they were not initially issued by a shell company. This use of the word "initially" in conjunction with footnote 172 is logical as it would allow Rule 144 to be used for the resale of shares of issuers that were not "shells" at the time the stock was issued, even if the issuer subsequently became a shell company. This interpretation would protect shareholders that purchased stock in an operating, non-shell company, which now hold and wish to sell their shares in a company that either was a shell prior to them purchasing their shares, or became a shell and then re-acquired operations, and allow them to sell their shares. Footnote 172 appears to support this position.

However, this possible exception to Rule 144(i) did not make it into the final version of Rule 144(i), as amended. Rule 144(i) merely states that the section is "not available for the resale of securities initially issued by an issuer" (emphasis added) with no or nominal operations and no or nominal non-cash assets. This overbroad language of Rule 144(i)(2), which prohibits shareholders of issuers that have "at any time previously" been a shell from utilizing Rule 144, prohibits these shareholders from utilizing Rule 144 to sell their shares. This result, and Rule 144(i)(2)'s broad application, renders the word "initially" in Rule 144(i)(1) virtually meaningless.

To confirm this was the intended consequence of these amendments, members of our firm discussed the issue with the SEC shortly after the amendments became effective. After thoroughly discussing the issues, including the fact that many operating companies, ones that had been operating for years, including being fully reporting and operating companies at the time the impacted shareholders purchased their shares, and ones that have not been shell companies for a decade or more, we came to the conclusion that it was the intent of the SEC in passing the amendments to Rule 144 to not allow these shareholders to utilize Rule 144. The SEC's response was that companies now had an avenue to allow their shareholders to utilize Rule 144, which was to use the "cure" provisions of Rule 144(i)(2) outlined above. The SEC views the amendments to Rule 144 as an expansion of the "Worm-Wulff Letters" concept by now allowing shell companies to "cure" their past status, making it clear the SEC has always viewed the Worm-Wulff Letters' prohibition on the use of Rule 144 for "blank check" companies, as also applying to shell companies. Although many practitioners never viewed the Worm-Wolff Letters concept as applying to shell companies, but only to "blank check" companies, this obviously was not the understanding of the SEC, which views the new amendments to Rule 144 as expansive in the area of shell companies and not more restrictive.

The Latest Developments

The SEC appears to be realizing the far reaching impact of Rule 144(i) on shareholders who purchased shares in companies that were not shells at the time they purchased or are not shells now, but were at some time in the past. In November 2008, Mr. Brian Breheny, the deputy director of the Securities and Exchange Commission's corporate finance division, stated that all companies that were ever shell companies are being caught up in Rule 144(i) and that is an "unfortunate result" and was "probably not something the Commission intended." He further stated that the SEC has already begun to move on this issue and that something should be forthcoming sooner rather than later.[1]

As of the date of this article, the SEC has not taken any action regarding Rule 144(i)'s unfortunate results. However, the SEC has clarified the result that Rule 144(i) does not have any room for interpretation. In its Compliance and Disclosure Interpretations ("C&DIs") issued on January 26, 2009, the staff at the SEC's Division of Corporate Finance answered the following question related to Securities Act Rules:

"Question: If an issuer had previously been a shell company but is an operating company at the time that it issues securities, is the Rule 144 safe harbor available for the resale of such securities if all of the conditions in Rule 144(i)(2) are not satisfied at the time of the proposed sale?

[1] For the full text of Mr. Breheny's comments see the Record of Proceedings from the U.S. Securities and Exchange Commission's Twenty-Seventh Annual SEC Government-Business Forum on Small Business Capital Formation Program at http://sec.gov/info/smallbus/sbforumtrans-112008.pdf pages 132-133.

Answer: No. Rule 144(i)(1) states that the Rule 144 safe harbor is not available for the resale of securities "initially issued" by a shell company (other than a business combination related shell company) or an issuer that has "at any time previously" been a shell company (other than a business combination related shell company). Consequently, the Rule 144 safe harbor is not available for the resale of such securities unless and until all of the conditions in Rule 144(i)(2) are satisfied at the time of the proposed sale. [Jan. 26, 2009]"[2]

Although the SEC staff's answer only directly responds to one possible shell scenario concerning Rule 144(i), the question and response really answers all the open issues as it relates to shell companies and Rule 144(i). There are only a few scenarios that a company can be in as a shell company that issued stock: (a) the company is a shell now and issued stock when it was a shell; (b) the company was a shell, then wasn't a shell when it issued stock, and is now a shell again; (c) the company was a shell and issued stock when it was a shell and now isn't a shell (but has not cured under Rule 144(i)(2)); (d) the company was a shell and is no longer a shell and issued stock when it wasn't a shell (but has not cured under Rule 144(i)(2)); or (e) the company was a shell at some point, but isn't now and has complied with Rule 144(i)(2).

Scenarios (a) and (b) are not really in dispute regarding Rule 144(i) since the company is currently a shell and the use of Rule 144 would be disallowed under Rule 144(i)(1)(i). Scenario (c) would also not be allowed under Rule 144(i)(1) because the shares were issued at a time the company was a shell so the shares were "initially issued" by a shell company. Scenario (d) is the scenario that many practitioners were hoping was left open by the use of the word "initially" and footnote no. 172, but is the one covered by the SEC's staff interpretation above, and the SEC's staff confirmed Rule 144(i)(1)(ii) prohibits the use of Rule 144 by shareholders of companies in this situation, even if they have not been a shell for some time. Under scenario (e) the company has complied with Rule 144(i)(2) and its shareholders would be eligible to use Rule 144.

On February 2, 2009, I spoke with Thomas Kim, Chief Counsel and Associate Director at the Office of Chief Counsel in the SEC's Division of Corporate Finance, regarding any forthcoming change in the amendments to Rule 144. According to Mr. Kim, the SEC's staff is aware of the concerns raised by securities practitioners as they relate to Rule 144(i), and are mindful of the issues surrounding the amendments to Rule 144, particularly Rule 144(i), but currently there is no proposed action to change the current Rule 144 and with the new administration and SEC Commissioner taking office there is no way to determine if any changes or amendments to Rule 144 will be forthcoming.

Conclusion

The February 2008 amendments to Rule 144 were well publicized for shortening the holding periods and removing certain restrictions necessary to use this resale exemption for issuers that are subject to the Exchange Act. Included in these amendments was Rule 144(i), which limited Rule 144's availability for shareholders of shell companies. Although the topic was discussed prior to the amendments taking effect, few foresaw the immense impact Rule 144(i) would have on shareholders of companies that are, or ever were in their past, shell companies. Non-affiliate shareholders that purchased stock in what were fully operating and reporting companies at the time of purchase, are many times now left with unsellable stock unless the company complies with Rule 144(i)(2), even though they had little or no say in the company becoming a shell company or the fact the company was a shell company at some point in its

[2] See http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm for the full transcript of the staff interpretations for January 26, 2009.

history. Hopefully this unfortunate result will be remedied by the SEC. In my opinion, the SEC will take a look at Rule 144(i) and its impact, and revisions will be a matter of "when" and not "if;" but with the new administration and a new SEC Commissioner, these revisions likely won't have priority and could be some time in coming.

(It should be noted that the determination of whether a company is a shell also has a bearing on whether the company can meet FINRA's listing requirements to become publicly-listed. This impact of being a shell company is outside the scope of this article, but continue to check our firm's website as an article on this topic will be forthcoming).

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The Lebrecht Group, APLC provides comprehensive advice on a variety of corporate and securities law matters. Please contact us if you have any questions.

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