THE ISSUING OF SHARES IN A PRIVATE COMPANY* CORRESPONDENCE

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My remarks will be directed to the problems that arise in determining how shares in a private company may be sold without breaching the provisions of the Securities Act.[1] The purpose of this topic is to bring to your attention a continuous and serious abuse of an exemptive privilege contained in the Securities Act, relating to private companies. I refer to Section 20 (2) (1) and I quote:

> Subject to the regulations, registration is not required to trade in securities of a private company issued by the private company where the securities are not offered for sale to the public.

The broad effect of this exemption, is that neither the company nor any person requires to be registered with the Securities Commission as a dealer or salesman of a dealer to trade in or sell shares issued by a private company.

Section 68 (a) of the Act in addition, provides that the prospectus filing requirements to be found in the Act are not applicable to trades in shares of a private company.

Over the past five years, the Securities Commission has had a never-ending problem, trying to control a substantial illegal sale of shares in private companies to the public, with resulting investment losses.

One method of combatting the situation would be to institute more stringent inspections of the share distribution of all private companies after they have been incorporated.

Another method would be to recommend to the Government that the exemption section be removed from the Securities Act altogether, so that prospectus and registration requirements would be applicable.

A third method, and the one which commends itself to me, is to elicit the support and the help of the legal profession.

I reject the first method because I am not by nature and I hope not by practice, a policeman, a dictator or hidebound bureaucrat. To investigate the distribution of shares in all private companies would require the addition of a number of Commission Investigators. Legitimate private companies would be subjected to a certain amount of unpleasantness. Talk and suspicion of a company and its principals often develop when it is known that the Commission is conducting an investigation. This could seriously impair the chance of the company succeeding, particularly if it is undertaking a new venture.

As for the second method, I am opposed to the suggestion that the exemption section be taken out of the Act. If this were to happen, private companies would be in an impossible situation. Their memoranda or articles would prohibit them from making a public offering of their securities, and at the same time the Securities Act would require a prospectus and a public offering to distribute their shares. Even with

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1 The Securities Act, R.S.A. 1955 c. 64.

appropriate amendments to the Companies Act[2] to overcome this difficulty, I cannot advocate any such legislative change. To do so would seriously dislocate a well-established part of our corporate machinery in the province. The whole essence of privacy would be destroyed.

The importance of the private company in Alberta is well demonstrated by the incorporation statistics from the Companies Branch. In 1961 there were 2,071 private companies formed, as compared to 21 public companies, and in 1962, 2,295 private companies as compared to eight public companies.

For want of a better approach, I have chosen the third alternative, and I believe that this requires a frank statement from me in connection with the origin of what I say is an abuse of the exemptive section. Having done so, I would then like to draw to your attention and discuss the rather scanty body of law relating to the distribution of shares in a private company.

I have no statistics on the number of private companies which are subjected to scrutiny by the Commission's staff during the course of a year. Sometimes our inquiry is brief and at others, it is very searching, depending upon the circumstances. You will have to take my word for the fact that there are many inspections made each year. These result from investors making inquiries of the Commission, from advertisements and literature that come our way, from complaints, and from our check on the activities of known offenders in the securities field.

Cases investigated involving a distribution of shares in a private company where an offence has been substantially established, and sometimes where prosecution follows, turn up two general characteristics. First: the private company was incorporated by one or more promoters of the irresponsible type who are have-nots, and who want to start a business on the public's money. These people usually envisage a good living, whilst selling shares in the company. They have little or no business experience and do not care particularly, or are not capable of judging, whether the venture is feasible.

The second characteristic (which has of course variations) is alleged advice received from a solicitor relative to raising capital for the enterprise. I say "alleged" advice because it is difficult to assess the veracity of some persons interviewed. There is so often too, the possibility that the solicitor was misunderstood by his client. I myself have been accused of giving a faulty opinion on a securities matter to someone who later came under investigation by the Commission. This second characteristic arises so frequently, however, that I feel justified in bringing it to the attention of the members of the profession and asking them to take particular care with clients, when advising how shares of a private company may be traded.

Another reason for being sound and careful in your advice, which I would like to mention in passing is this: where an accused seeks to rely upon any of the exemptions and exceptions such as that relating to private companies, it is for the accused to adduce evidence to show that he comes within the terms of the exemption or exception. This is so

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2 The Companies Act R.S.A. 1955 c. 53.

because the Summary Convictions Act[3] in Alberta makes applicable the provisions of Part XXIV of the Criminal Code, including Section 702.[4]

Two statements of advice are allegedly given by some solicitors, without any additions or qualifications. They may be stated thus: "You don't need to be concerned with the Securities Act or require registration, because a private company can have fifty shareholders. If you sell shares to not more than fifty people, you don't need to go near the Commission."

True—up to a point.

The second form of advice is as follows: "You can sell shares in a private company without registration under The Securities Act, if you sell them to your friends, relatives and business associates only".

True, but requires qualification.

Before examining these statements, I would like to make a few general observations on the development of corporate legislation and its recognition of the need to protect the public in the sale of securities.

If you will turn back the pages of history to the "Bubble Act" of 1719,[5] you will find this an attempt to check an orgy of speculation in shares and securities and resulting frauds. Unfortunately this Act checked the development of a capital market in Britain for almost a century. It also meant that only those companies operating by Royal Charter were officially recognized. Despite the Bubble Act, however, unincorporated companies were formed by deeds of settlement, shares were issued and made transferrable and their popularity grew. The Bubble Act was repealed in 1825[6] and there followed statutory recognition of unincorporated companies which were able to obtain limited liability by letters patent. In 1862 the Companies Act in Britain[7] recognized and introduced the private company, providing that it could be incorporated with only two members.

This was the vehicle used extensively by sole proprietors, partnerships and family concerns, to avoid the risk of personal responsibility for the debts of the business which was being carried on. Incorporation also made it possible for the business to be preserved and carried on unhampered, upon the death of one of the principals or the founder. Shares were transferrable from father to sons, generation after generation. It has been suggested by one text-book writer, that the large number of fifty shareholders authorized by the various Companies Acts was to allow for a division of shares amongst the members of large families.

Be that as it may, historically speaking, private companies were not incorporated to sell shares to the public in order to obtain financing, nor did one subscribe to shares in a private company merely as an invest-

3 The Summary Convictions Act R.S.A. 1955 c. 325.

4 Criminal Code (Can.) 2-3 Eliz. 2 c. 51 s. 702:

"702(1) No exception, exemption, proviso, excuse or qualification prescribed by law is required to be set out or negatived, as the case may be, in an information.

(2) The burden of proving that an exception, exemption, proviso, excuse or qualification prescribed by law operates in favour of the defendant is on the defendant, and the prosecutor is not required, except by way of rebuttal, to prove that the exception, exemption, proviso, excuse or qualification does not operate in favour of the defendant, whether or not it is set out in the information."

5 (Imp.) 6 Geo. 1, c. 18, An Act "for restraining several extravagant and unwarrantable practices herein mentioned".

6 (Imp.) 6 Geo. 5, c. 91.

7 (Imp.) 25826 Vict., c. 89.

ment. It would seem that members were not merely regarded as shareholders. They were a part of the business itself. The restriction on the transfer of shares which is part and parcel of all private companies, is further evidence that the association of individuals was intended to be a close, personal and private relationship.

The statutory law with respect to private companies has been little changed in the past century in this country and in Britain. That relating to public companies, however, has been subject to many changes. Included in succeeding Companies Acts, we almost always find statutory safeguards to protect the public with respect to public offerings of shares. In addition, of course, separate securities legislation has been enacted in most countries.

There are two general securities controls now recognized, whether in corporations acts or in securities acts. Firstly, persons trading in securities require registration, and secondly, no issue shall be offered to the public unless the offer is accompanied by a prospectus which makes full, true and plain disclosure, with respect to the company itself, its directors, officers, promoters, properties, outstanding contracts, promotional consideration, share structure, offering price and so on.

However, no such requirements are necessary to trade in the shares of a private company, because the company is prohibited from making a public offering of its shares. If a person is invited to participate in the formation of a private company, or later to become a member, he has no prospectus to rely upon—nor should this be necessary.

He is, or should be dealing with someone he knows well and intimately; someone he may trust and rely upon and with whom he wants to join in the venture as a business partner.

The popular conception of a private company, according to Pennington, in his *Principles of Company Law*:

> . . . is of a small concern with few shareholders most of whom are actively engaged in managing the company's business, and who regard their shares not merely as an investment but as the source of their livelihood. In other words a private company is visualised simply as an incorporated partnership. On the whole this picture is an accurate one. Numericallly, private companies are far greater than public ones, but their total paid up share capital is little more than half of that of public companies . . . This does not mean that all private companies have small share capitals and possess assets of only a small value, however. There is no legal limit on the amount of share capital which a private company may issue, and some of them have larger issued capitals than many public companies. The choice whether a company shall be a public or private one is determined only in part by the amount of capital which it needs to raise. Far more important is the source from which the capital is to come; if it can be subscribed by a small group of persons, the company will be a private one, but if it will be necessary to invite the public to subscribe, the company will have to be a public company.[6]

I am aware that in recent years, some private companies in this country have taken on more of the aspects of a public company, and there is not that close participation in management in many instances. The statutory definition of a private company, however, remains unchanged.

Let us now go back and consider more carefully the two alleged statements of advice to which I referred earlier. To refresh your memories, the first is, generally speaking, along this line: "You can

6 Pennington, *Principles of Company Law* 485 (1959).

have fifty shareholders and if you don't go beyond this, you don't need registration under the Securities Act." This is only partly true. The Companies Act[9] in Alberta permits a private company to have with exceptions, fifty shareholders, but this Act does not regulate or control the trading of securities, including those issued by a private company in Alberta. One must look to the Securities Act for this. Nowhere in our Securities Act is there any reference to fifty members. The privilege accorded to a private company in the Act is the exemptive section to which I have referred. The test to be applied is not whether the trading involves one person or fifty persons, but rather whether the method used to acquire capital involves an offering of the shares to the public. If such is the case, and if there is a public offering, then it follows that the person or company making the offering is not accorded the privilege of the exemption offered in the Act, and an offence is committed.

The second proposition, which I will repeat to refresh your memory again, is this: "You can sell shares in a private company to your friends, relatives and business associates." As I mentioned before, this may well be true, but it requires careful qualification. Once again, the exemption section in the Securities Act[10] does not say that registration is not required to trade in the securities of a private company provided the trades are made with friends, relatives and business associates. The exemption from registration provides that registration is not required in respect of:

> . . . securities of a private company issued by the private company where the securities are not offered for sale to the public.

If you are going to trade in shares issued by a private company without registration, you should be able to establish that in the course of trading, you did not make an offering of these shares to the public.

In order to advise your client properly, you must be able to give some guidance on the meaning of the words "offering to the public". What is "the public"? The expression public, itself is not defined in the Securities Act,[11] and yet a solicitor must be able to translate the general expression into something specific and understandable to his client. Some assistance may be obtained by consulting your dictionaries and cases. A statement by Lord Justice Scott commends itself to me. This is found in *Tatem Steam Navigation Co. Ltd.* v. *Inland Revenue Commission:*[12] "There is no reason why the word public should be given anything but its ordinary meaning". He then went on to approve the definition found in *Murray's New English Dictionary* which defines "public" as: "the community as an aggregate, but not in its ordinary capacity, hence the members of the community".

In the case of *Nash* v. *Lynde,*[13] where the word "public" is discussed, one of the questions dealt with was whether the documents did in fact constitute a prospectus within the meaning of the applicable English Companies Act. It was held that the offer to the public of share capital must be made by the company itself and not some individual without

9 *Supra*, n. 2.
10 *Supra*, n. 7.
11 *Ibid.*
12 [1941] 2 K.B. 194.
13 [1929] A.C. 158.

the authority of the company. Thus, it will be seen that the words "offer to the public" were properly in issue. Lord Hailsham stated:

> My Lords, I should be loathe to hold that in order to bring Section 81 of the Act of Parliament into operation, it must be proved that the prospectus in question had been published to any defined number of persons or that a plaintiff who had been misled by a prospectus which did not comply with the statutory requirements, must fail in his action unless he could prove that it had been published to persons other than himself. In my judgment, it is sufficient in order to bring Section 81 into operation, that the prospectus in question should be proved to have been shown to any person as a member of the public and as an invitation to that person to take some of the shares referred to in the prospectus on the terms therein set out.

Viscount Sumner, at Page 169, states as follows:

> 'The Public', in the definition s. 285, is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole.

We find no definition of the expression "offered to the public" or "public", either in the Interpretation Act[11] in the Alberta Satutes, The Companies Act[15] or the Securities Act.[16]

You may be interested to know, however, that the expression "offered to the public", is found defined in the Dominion Companies Act.[17] This definition, you may also note, explicitly states that it does not apply to a private company.

You will also find in Section 82 (4) of the Dominion Companies Act the definition of the word "public". The section itself, is one dealing with the distribution of securities of a public company, and in particular it provides that it is not lawful for any person acting for or on behalf of a company, to call at any residence for the purpose of offering securities of such company to the public or any member of the public, for subscription. The world "public" as used in that subsection is then defined in a negative sense, as follows:

> Public does not include those personal friends, business associates or customers with whom the person making the offer has been in the habit of doing regular business in the sale of or obtaining subscriptions for securities in the past.

A somewhat less stringent and yet similar provision to that found in the Dominion Companies Act with respect to calling at a person's residence or telephoning thereto, is found in the Alberta Securities Act itself, Section 80 (3).[18]

Assuming that we were to take the definition of public out of the Dominion Companies Act and incorporate it in the Alberta Securities Act, I would suggest that you, as solicitors, would still not be out of the woods. If this definition were used, you would still have to go one step further, and define to your clients the meaning of the terms "a close personal friend", a "business associate" and a "customer".

The problem which arises from the use of these general categories is pointed out quite clearly by His Honour Judge Lennox in R. v. *Empire Dock Ltd.*:[19]

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11 The Interpretation Act, 1958 (Alta.) c. 32.
15 *Supra*, n. 2.
16 *Supra*, n. 7.
17 Companies Act R.S.C. 1952 c. 53, s. 73(a).
18 *Supra*, n. 7.
19 (1940) 55 B.C.R. 34, 37.

> In this connection it seems to me that not only reason but all the authorities stress that point that the meaning of the words 'the public' cannot be tied down to a specific quantity and that, when the term is used, it must be considered as relative to the question at issue and the circumstances of each particular case. Even the words 'friend' 'customer' and 'connection' must also not be narrowed to the particular from the general. A man may call another his friend and yet may be a mere nodding acquaintance. A man may refer to another as his customer and yet he may only have bought one articles of goods from him, and that years before. A man may call another a connection and yet in a business, as well as a family sense, may be so distant a connection that the word is not suitable and conveys a wrong impression. In view, therefore, of this latitude allowed in the use of such expressions, it becomes all the more necessary to carefully distinguish the dividing line to which, in the certain circumstances of the particular case, the person seeking to define these words, has to direct his attention.

In Alberta, I personally use the expressions "close friends and relatives and business associates" to indicate those persons who may properly be invited to participate in a private company. It is a guide I would suggest, only because it is from these three categories of individuals—close personal friends, close relatives and business associates —that one would normally seek "know how", financial assistance, and from whom one would draw partners to engage in a business venture as a private corporation. I would urge that solicitors explore their client's plans for acquiring capital in a private company very carefully. Many promoters, obviously have few if any close relatives who would be in a position to put up much money. The same may be true of their really intimate friends and business associates, if they have any. These matters, I think, should be probed by the solicitor with his client, before he can properly advise the client whether his particular needs are suited to a private company, or whether the capital should be raised if at all, by a public invitation to subscribe for shares pursuant to a prospectus.

Most of the reported cases dealing with this knotty problem of what is an offering to the public, are decisions dealing in fact with public companies. They generally revolved around the question of whether a certain document, or "send out" as they are sometimes called, was a prospectus and amounted to a solicitation, or invitation to invest, thereby constituting a public offering. Such cases are relatively easy to decide on their facts.

It is much more difficult when the company proposes to acquire members through the sale of shares by personal contacts of the company's promoters, directors or officers. Case law dealing with this particular problem was non-existent, so far as I am aware, until 1959 when we were fortunate in having a reported decision given by the Appellate Division of our Supreme Court in Alberta. The decision itself was written by Mr. Justice Hugh John Macdonald.[20] As this decision is readily available I do not propose to discuss in detail the facts and the law therein decided, but I will quote two paragraphs from the decision. I do so because I feel that Mr. Justice Macdonald has caught the very essence and meaning of a private company. Although he expresses the latitude to be given in acquiring shareholders and selling shares in different words than my own, at the same time, he has provided us all with a yardstick that is well worth keeping in mind:

> It seems to me that the very essence of a private company envisages the idea that it is of private, domestic concern to the people interested in its formation

[20] *R. v. Pipegrass* (1959) 29 W.W.R. 218.

> or in later acquiring shares in it. It is one thing for an individual or group of individuals to disclose information to friends or associates, seeking support for a private company being formed or in existence, pointing out its attractions for investment or speculation as the case may be, but it is quite another thing for a private company to go out on the highways and byways seeking to sell securities of the company and particularly by high pressure methods, that is, by breaking down the sales resistance of potential purchasers and inducing them to purchase.
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> It is clear from the case cited and from the authorities cited, that it is impossible to define with any degree of precision what is meant by the term "offer for sale to the public". It follows that in each instance the Court will be called upon to determine whether or not the sale of the securities of the private company transcended the ordinary sales of a private domestic concern to a person or persons having common bonds of interest or association. It is clear from the authorities that whether or not there was an offering to the public is a finding of fact.

If you read this decision you will observe that the Court below was readily able to distinguish between an offering to the public and the proper acquisition of shareholders in a private company. The Court of Appeal using its yardstick came to the same conclusion that there had been a public offering.

What persons can we say with reasonable certainty have common bonds of interest? I suggest to you that the expression "close personal friends" might come within this, but not mere acquaintances or someone you have known casually for years. Certainly business associates would fall within this general expression, but not customers to whom you may have sold a magazine subscription, or even a share issue on one occasion. In some cases, even relatives might be said to have a real common bond of interest provided there is a normal closeness between the parties and not just some tenuous blood tie.

In conclusion, I would like to say, that my purpose is not to teach you anything about the law relating to private companies, but rather to bring your attention to the fact that the law relating to the distribution of securities in a private company is one that is fraught with difficulty and danger, so far as your clients may be concerned.