Rule 144: A Shell Game

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On December 6, 2007, the Securities and Exchange Commission issued a release detailing amendments to Rule 144 under the Securities Act of 1933. For most investors, these amendments substantially reduced limitations on the resale of restricted securities. While these amendments represent a significant step forward, they negatively impact one group of companies and its shareholders.

As amended, Rule 144 includes a public information requirement targeting companies that were formerly "shell companies" (generally companies with nominal or no operations and nominal or no assets). Rule 144 specifies that investors in former shell companies, known as shell investors, may not rely on Rule 144 unless the company has filed all reports required under the Securities Exchange Act of 1934 during the prior 12 months. This restriction applies to any company that was ever a shell company. Yes, *ever* a shell company, and therein lies the problem.

Background

Rule 144 is the principal means for investors to resell restricted securities. If a selling shareholder meets Rule 144's requirements, he is deemed not to be engaged in a distribution and may resell without violating the Securities Act. As amended, Rule 144 is available to investors in former shell companies but not to investors in current shell companies.

Prior to the recent amendments, Rule 144 did not specifically address resales by shell investors. However, in a January 2000 letter from the SEC to the NASD, the SEC concluded that Rule 144 was not available for the resale of securities issued by companies that previously were blank check companies (similar to shell companies). The SEC noted that regardless of technical compliance with Rule 144, the rule was not available because these transactions "appear to be designed to distribute or redistribute securities to the public without compliance with the registration requirements of the Securities Act."

The SEC's letter revealed its view that shell companies and former shell companies are associated with abuse of the federal securities laws, particularly by serving as vehicles to avoid the SEC's registration requirements. The recent amendments to Rule 144 appear to confirm the SEC's position.

The Problem

Rule 144's public information requirement will inevitably cause dyspepsia for shell investors. These investors may find themselves unable to sell their shares under Rule 144 because the companies in which they have invested fail to keep their Exchange Act filings current. Because Rule 144's public information requirement lasts forever, these investors may face the unpleasant reality that their shares are effectively locked up.

Stock certificates for unregistered securities contain a "restricted" legend. Investors often seek to have this legend removed to avoid the problems associated with selling "legended" shares. The SEC does not object to removing

restricted legends on certificates held by non-affiliates once all Rule 144 requirements have been met. For most investors this means simply holding the shares for one year. However, Rule 144's public information requirement makes it unclear whether restricted legends may *ever* be removed from former shell company shares. Although many do not believe that this was the SEC's intent or that this is the best interpretation of Rule 144, the new rule will likely create confusion. No doubt some former shell companies and their counsel will argue that legends may not be removed prior to a resale.

Rule 144's public information requirement may exacerbate the problems the SEC tried to fix. In amending Rule 144, the SEC intended to increase the liquidity of privately sold securities and decrease costs of capital without compromising investor protection. The public information requirement stigmatizes former shell companies. This stigma makes it difficult for these companies to raise capital, and reduces their overall value. Additionally, Rule 144's public information requirement makes resale more difficult and decreases liquidity for shell investors. Query whether the SEC is trying to dissuade companies from utilizing the shell company structure. No doubt this will negatively impact demand for current shell companies.

That said, prior to the recent Rule 144 amendments, the SEC decreed that shell investors could not rely on Rule 144. By lifting that restriction the SEC seems to be recognizing that not all former shell companies are quite so bad. The SEC cast too wide a net by imposing restrictions on every former shell company. Ideally, the SEC will soon revisit this issue and focus its efforts. Many former shell companies are thriving, and Rule 144's public information requirement may unfairly target some of these productive companies.

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