

Beware of Lawyers Bearing Gifts (With Respect to Rule 144 Opinions)

Corporate and Securities Law Alert

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Investors in private placements of securities are subject to legal constraints on their ability to freely resell those securities, and responsible investors readily abide by those constraints.

These restrictions include a minimum holding period for the securities, which is intended to ensure that the investor is subject to meaningful market risk consistent with the nature of a private placement. Some securities professionals, including attorneys, have created entire lines of business designed to enable investors in private placements to evade the legal restrictions on reselling their restricted securities, and this article will describe some recent examples of this activity, including the efforts of the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) to combat this activity.

Background

The Securities Act of 1933 (the Securities Act) makes it illegal to offer or sell securities without filing a registration statement with the SEC unless an exemption from registration is available. The certificates representing restricted securities are typically stamped with a legend indicating that they cannot be resold unless they are registered pursuant to the Securities Act or exempt from registration. If a legitimate exemption is available, the restrictive legend is removed from the certificate by the transfer agent, enabling the securities to be resold. Transfer agents often require the issuer of securities to provide a legal opinion from its counsel to the effect that the proposed resale is exempt from registration before removing the restrictive legend from the certificate, making the issuer's attorney the "gatekeeper" whose consent will enable securities to be freely traded. Once the restrictive legend is removed, the shares may be freely sold on the stock market through any stockbroker.

Abused Exemptions

Section 4(2) of the Securities Act exempts transactions by an issuer not involving any public offering. Because of the difficulty in interpreting Section 4(2), the SEC adopted Regulation D which provides a safe harbor from registration pursuant to Section 4(2). Regulation D provides three exemptions, including one in Rule 504 that, subject to a number of conditions, provides an exemption from registration for the sale by an issuer of securities not exceeding \$1 million.

A purchaser who acquires restricted securities and wishes to resell the securities must then rely on a resale exemption (as opposed to the exemptions for issuer sales provided by Regulation D). Investors may acquire

restricted securities through Regulation D offerings or other private placement offerings, under unregistered stock-based employee benefit plans for directors and executive officers, or through offshore placements under so-called Regulation S. Subject to a number of conditions, Rule 144 provides an exemption from registration for an investor's resale of restricted securities.

To rely on the safe harbor provided by Rule 144 under the Securities Act, a number of conditions must be met. Among these is a requirement that the securities must be held for the requisite minimum holding period (if the issuer is subject to the Securities Exchange Act of 1934 (the Exchange Act) the holding period is six months, otherwise the holding period is one year), and the availability of adequate current information about the issuer (generally meaning that the issuer must be in compliance with the reporting requirements of the Exchange Act).

Recent Cases

The SEC and the DOJ have recently brought a number of charges alleging the fraudulent issuance of legal opinions by attorneys, which have enabled restricted securities to be freely traded in violation of the securities laws.

Stephen J. Czarnik

In February 2010, the SEC filed charges against securities lawyer Stephen J. Czarnik, asserting participation in a multi-million-dollar pump-and-dump stock scheme. As legal counsel to three companies, Czarnik issued legal opinion letters stating that offerings were in compliance with a private placement exemption under Rule 504 of the SEC's Regulation D and authorized the transfer agent to issue stock certificates without a restrictive legend, facilitating their free transferability. Rule 504 generally allows issuers which are not SEC-reporting companies¹ to sell up to \$1 million of securities in any one year. The stock of many smaller public companies is traded through the "Pink Sheets," a largely unregulated electronic quotation and trading system in the over-the-counter securities market which does not require issuers to file periodic reports with the SEC, thereby enabling smaller, non-reporting issuers to take advantage of Rule 504. In this case, the SEC alleges that Czarnik knew or was severely reckless in not knowing that no securities law exemption was available in these offerings.

The complaint alleges that Czarnik falsely represented that stock promoters intended to hold the shares of the companies (a necessary element for the exemption to apply), when instead they distributed the shares into the public market after holding them for only a brief period during which they advertised and sent promotional mailers ("ACT NOW BEFORE THE WHOLE WORLD FINDS OUT ABOUT THIS STOCK!"). The SEC asserts that Czarnik knew that the three promoters intended to distribute the stock at the time he issued the opinion letters, pointing to e-mail traffic discussing the plans for advertising and immediate distribution ("[W]e are ready to sign and start trading.") and an SEC suit against Ryan Reynolds, one of the promoters, in 2007 alleging participation in the unregistered resale of penny stock. The SEC is seeking, among other things, disgorgement of the gains related to the scheme and civil penalties.

144 Opinions, Inc.

In May 2009, the SEC filed a complaint against 144 Opinions, Inc., asserting that the company operated as a legal "opinion mill" which fraudulently facilitated the sale of securities in violation of the registration provisions of the

federal securities laws. The complaint alleges that Sandra Masino (the owner of the company), and attorneys Albert J. Rasch, Jr. and Kathleen R. Novinger of Albert J. Rasch & Associates, prepared and issued at least 24 legal opinion letters that induced the removal of restrictive legends on unregistered shares of Mobile Ready Entertainment Corp., resulting in the sale of 22 million shares to the public in violation of Rule 144.

144 Opinions, Inc. operates its business primarily through a Web site, www.144opinions.com. As part of the scheme alleged by the SEC, Masino would input shareholders' information into a database and prepare a template of an opinion. Rasch's firm would then make an independent decision as to whether to issue the opinion. Masino charged customers \$259 for the opinions she prepared and paid Rasch and Novinger \$45 for each opinion executed. Typically, the attorneys would have no direct contact with the shareholder. The defendants claimed that before issuing their opinions, they obtained the necessary back-up information from the SEC's EDGAR filings database. The SEC asserted, however, that Mobile Ready Entertainment Corp. had not filed any documents with the SEC at the time the opinions were issued. The SEC further asserted that the defendants knew, or were severely reckless in not knowing, that the legal opinions contained false and misleading statements.

William D. O'Neal

In August 2008, the SEC filed charges against Alliance Transcription Services and others, asserting that the defendants manipulated Alliance's stock prices and trading volume through false and misleading public disclosures and issuing and selling the stock in an unregistered distribution. Charges were also brought against William D. O'Neal, the attorney who issued the opinion letters that enabled Alliance to issue the purportedly unrestricted stock. Simultaneous with filing the complaint, the SEC settled the charges against O'Neal. The settlement required him to disgorge more than \$220,000 of gains and prohibited him from issuing similar legal opinions concluding that unregistered offerings are exempt from SEC registration under Rule 504 of Regulation D and that the securities issued in such offerings are unrestricted.

Phillip Windom Offill, Jr.

In March 2009, the DOJ filed charges against securities attorney Phillip Windom Offill, Jr., alleging that he participated in a stock registration evasion scheme that allowed millions of unregistered shares of 9 different companies to be freely traded that were not legally entitled to be freely tradable.² The charges further assert that as part of the conspiracy orchestrated by Offill, legal opinions were issued in connection with a "pump-and-dump" scheme that facilitated the creation of new companies with no assets and the issuance of unregistered securities to co-conspirators, after which the co-conspirators inflated the prices of the stock by publicly issuing materially false statements about the companies and then sold their stock to the investing public at artificially inflated prices.

According to the SEC, one or more co-conspirators issued legal opinion letters that gave the appearance that the companies were complying with an exemption provided by Rule 504 of Regulation D and its Texas securities law counterparts. Under Rule 504, if the offering is conducted under a state securities law exemption that permits general solicitation and general advertising in connection with sales made to accredited investors, the shares may be freely resalable and a Securities Act restrictive legend is not required to be placed on the stock certificates. Texas has a state securities law exemption that permits limited advertising in offers and sales to accredited investors who acquire the securities for investment and not with an intention to engage in a distribution of the security, and the issuer of the legal opinion in the Offill case attempted to rely on this Texas law to justify the

issuance of stock without a restrictive legend. For purposes of the Texas law, any resale within 12 months, except to other accredited investors, is presumed not to comply with the Texas exemption, and Offill and his co-conspirators knew that there was no intention to hold the shares for the requisite period.

In this case, the conspirators facilitated the sale by the issuers to accredited investor entities resident in Texas and controlled by Offill, which would then immediately resell the securities to co-conspirators, using false representations to the transfer agent to acquire unlegended stock certificates in contravention of federal and state securities laws. The co-conspirators would then illegally sell the purportedly “free trading stock” of small public companies to the general investing public through listings on the Pink Sheets marketplace.

Offill’s involvement was primarily related to facilitating the unregistered issuance of the shares, then his co-conspirators would take over the “pump” phase. Offill hid his profits from the scheme by billing legal fees to co-conspirators, including a transaction in which an entity he controlled purported to purchase common stock from an issuer. Offill’s participation resulted in his conviction in January of 2010.

Additional Policing Activity

The SEC issued a statement as early as 1962 providing guidance for exemptions based on legal opinions stating that “[i]t is the practice of responsible counsel not to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution unless such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not part of an unlawful distribution.”³ Further, “if an attorney furnished an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.”⁴

In addition to the SEC and the DOJ, the Pink Sheets marketplace is making an effort to police opinion letters. The Pink Sheets Web site includes a publicly available list of firms and attorneys from which it will not accept legal opinions.

Responsible securities lawyers will review all of the relevant paperwork and facts relating to a proposed removal of a Securities Act restrictive legend from a stock certificate. Among other things, the attorney will require the submission of signed factual certifications from the shareholder and the broker, confirming the accuracy of relevant information, including, among other things, how long the shareholder has held the securities. Any discrepancy between the certifications and any related paperwork requires further due diligence by the attorney to verify the underlying facts. Only after thoroughly vetting the relevant facts and confirming the legitimate availability of an exemption from registration will a responsible attorney issue the necessary legal opinion to permit the removal of the restrictive legend.

Conclusion

The highest level of diligence and care must be taken by attorneys issuing legal opinions with respect to registration as they are relied upon by financial intermediaries and the investing public. Similarly, shareholders and issuers should take great care when dealing in restricted securities to ensure that their securities law attorney is

not leading them down a path that will attract the negative attention of the SEC and DOJ.

Endnotes

¹ Generally, companies with fewer than 500 shareholders of record or less than \$10 million of total assets as of the beginning of a fiscal year, and which have not filed a registration statement for the public offering of securities that has been declared effective by the SEC, are not required to file periodic reports with the SEC.

² This was not the SEC's first allegation of misconduct. Offill was a defendant along with Ryan Reynolds in the 2007 case referenced above under "Stephen J. Czarnik."

³ Distribution by Broker-Dealers of Unregistered Securities, Securities Act Release No. 4445, Exchange Act Release No. 6721 (February 2, 1962).

⁴ *Id.*

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