

PRESTO: A NEW TEST FOR INADVERTENT INVESTMENT COMPANIES

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THE SEVENTH CIRCUIT HAS CREATED UNCERTAINTY
IN A RELATIVELY SETTLED AREA OF LAW

Court cases involving investment company status are few and far between and generally have been decided at the lower-court level. Recently, the Seventh Circuit visited this issue in *SEC v. National Presto Industries*, 486 F.3d 305, (CA-7, 2007) (*Presto*). *Presto* adds a new gloss to the SEC's historical interpretation of what it means to be "primarily engaged" in the investment company business.

The SEC's longstanding interpretation is *In re Tonopah Mining Co.*, 26 S.E.C. 426 (1947) (*Tonopah*). *Tonopah* set forth five factors to determine whether a company was operating as an inadvertent investment company:

1. Company's history.
2. Its public representations.
3. Activities of its officers and directors.
4. Nature of its assets.
5. Sources of its income.

All of these factors served as a proxy for what a "reasonable investor" would believe to be an investment company. *Tonopah* identified the most important factor as whether "the nature of the assets and income of the company...was such as to lead investors to believe that the principal activity of the company was trading and investing in securities." This approach produced a relatively mechanistic, bright-line test that provided some degree of certainty in analyzing whether a company was an inadvertent investment company.

In *Presto*, however, the Seventh Circuit instead interpreted *Tonopah's* five factors as being subordinate to a relatively subjective factor: the per-

ception of a reasonable investor. In other words, the court flipped the *Tonopah* test around to make the perception of a reasonable investor the leading inquiry, rather than letting the *Tonopah* test serve as the proxy for what a reasonable investor would believe. To this end, the Seventh Circuit chastised the SEC for not producing "even one confused investor" who believed that *Presto* was an investment company.

The Seventh Circuit's decision produces two significant results. First, given the inherently subjective "reasonable investor" perception test, companies now have a potential shield to protect them from being considered an inadvertent investment company, particularly if they do not meet the five-factor *Tonopah* test.

Second, it introduces the possibility that the SEC will try to develop the "reasonable investor" test as an additional weapon in its enforcement artillery. For example, if a company is not deemed an inadvertent investment company under the *Tonopah* test, the SEC might then seek out reasonable investors to attest that they believe the company is one.

Unfortunately for practitioners, the court did not provide any guidance on the contours of the reasonable investor perception test. Therefore, it remains to be seen how much *Presto* helps or hurts issuers with investment company status issues.

FACTS

Presto, a New York Stock Exchange-listed company, designs and markets small appliances and housewares, most of which are currently manufactured by subcontractors. *Presto* also manufactures and distributes absorbent products and munitions. Over the past 30 years, *Presto* sold its

subsidiaries and decreased its manufacturing operations, subcontracting much of its product manufacturing to others. This left *Presto*, in 1993, with a large supply of cash, most of which it used to acquire refunded bonds and variable rate demand notes to build up a "war chest" for future acquisitions. *Presto* also acquired intellectual property that, consistent with accounting principles, was not carried on its books at its full economic value. As a result, while *Presto* had substantial operating income, its operating assets consisted mostly of securities.

The SEC filed suit against *Presto* in 2002, alleging that it was an investment company, which *Presto* characterized as "a strained interpretation of an obscure section in a 62-year-old law." The district court granted the SEC an injunction, and the SEC ordered *Presto* to register as an investment company, which it did a few weeks later.

Presto then sustained a nasty fallout from the SEC's injunction. The company's auditor resigned due to the SEC's concern about its certification of *Presto's* financial statements. The auditor then refused to allow *Presto* to use any of its certified financial statements. As a result, *Presto* could not file any of its required financial reports, and the NYSE threatened to delist it.

COURT'S ANALYSIS

Presto's troubles arose because more than 40% of its total assets were invested in investment securities, and it was not otherwise excepted from the definition of "investment company." Under the Investment Company Act of 1940 (Investment Company Act), an "investment company" is defined as:

any issuer which...is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.¹

Many of Presto's assets were invested in refunded bonds and variable rate demand notes. Presto argued unsuccessfully that these should be considered government securities and cash items, respectively, and therefore not included in the 40% total assets test. The Seventh Circuit strictly construed the definitions of government securities and cash items, and pointed out that Presto had bought those securities because they produced a higher rate of return, which helped compensate for their increased risk. As a result, the refunded bonds and variable rate demand notes were included in both the numerator and the denominator used in calculating Presto's 40% total assets test.

Presto next asserted that, assuming it failed the 40% total assets test, it nonetheless was entitled to be excepted from the definition of investment company because it was not "primarily engaged in investing, reinvesting, owning, holding, or trading in securities."² Although issuers may self-determine that they are not an investment company because they are not "primarily engaged" in these activities, in practice, many issuers with substantial amounts of securities assets (such as Microsoft and Yahoo) apply for an SEC finding that they are not engaged in such activities.³

"Primarily engaged" is not defined by statute or rule. The SEC's interpretation was developed 60 years ago in *Tonopah*. As noted earlier, *Tonopah*'s five factors were (1) the company's history, (2) its public representations of policy, (3) activities of its officers and directors, (4) nature of its assets,

and (5) sources of its income. Over the years, the *Tonopah* test has served as a somewhat formulaic proxy for whether a reasonable investor would believe a company to be an investment company. The SEC staff views the assets and income factors to be the most important.

In reviewing the *Tonopah* factors, the Seventh Circuit dispensed easily with the first three, finding that Presto's history and public representations had always been that of an active business selling consumer and military products, and that Presto's directors were primarily engaged in running Presto's operating business. The court also chastised the SEC for arguing that a firm "with such a substantial ongoing presence in product markets is an inadvertent investment company."

The Seventh Circuit, however, in a significant departure from long-standing SEC positions on the assets and income tests, treated them as a single test, focusing on whether the company's assets and income would lead an investor to believe that the company was an investment company. The SEC typically has viewed these factors as separate inquiries. Although more than 60% of Presto's assets were in investment securities, the Seventh Circuit said that the balance sheet had "a potential to mislead," given that Presto had substantial patents and trademarks that were not carried at market value on Presto's balance sheet. As for income, over 90% of Presto's gross income was from its sales of goods, such as popcorn poppers and puppy pads. Nevertheless, the SEC and the Seventh Circuit disagreed about Presto's net income, and in the end, the Seventh Circuit decided that 60% of Presto's 2005 net income was from its sales.

The Seventh Circuit stated that *Tonopah* identified the most important factor as whether "the nature of

the assets and income of the company...was such as to lead investors to believe that the principal activity of the company was trading and investing in securities" [emphasis added].⁴ In other words, the *Tonopah* test was not a proxy for what a reasonable investor would believe to be an investment company, but was simply a set of factors that could be outweighed by a reasonable investor's perception. To this end, the court somewhat indignantly pointed out that the SEC "did not identify even one confused investor who bought stock in Presto thinking that he was making an investment" in an investment company. The court then found that although Presto's assets and income generally exceeded the thresholds for a noninvestment company, Presto was nonetheless not an investment company, simply because no "reasonable investor" would think Presto was actually an investment company.

The court was irritated by what it saw as the SEC's attempt to steamroll Presto. It characterized the SEC as being "in a snit" because Presto refused to seek an order and chastised it for forcing Presto investors to bear the "unnecessary costs" of Presto's registration as a closed-end fund, asking "[w]hy is the SEC bent on grinding down a corporation that it appears to acknowledge would not mislead or otherwise injure investors by using the governance and reporting devices appropriate to an operating company?"

Bad facts often make bad law. The court created uncertainty in a relatively settled area of law, as it subordinated the relatively straightforward

¹ Section 3(a)(1)(C).

² Section 3(b)(1).

³ Applicants may request such an order under section 3(b)(2).

⁴ 2007 U.S. App. LEXIS 11345 at *26, quoting *Tonopah* at 430.

Tonopah factors to the ambiguous “reasonable investor” perception test. In so doing, the court did not provide any guidance on how the SEC or companies should assure themselves of what a reasonable investor would believe. For example, should the “reasonable investor” perception test resemble other reasonable investor inquiries (e.g., Rule 10b-5 actions, prospectus disclosures, and Regulation FD disclosures), or should companies conduct focus group tests?

CONCLUSION

There is no clear answer on whether *Presto’s* net effect will be positive or negative for issuers or whether it will be followed by other jurisdictions. On one hand, the decision might give companies with Investment Company Act status problems a shield in defending their status. If they can demonstrate that no reasonable investor would view them as the equivalent of a mutual fund or closed-end fund, the inquiry is over—at least in the Seventh Circuit. On the other

hand, the SEC might use that weapon against a company by producing reasonable investors who hold the opposite view. Practitioners may find it more difficult to give clean opinions on a company’s status, given the murkiness of the “reasonable investor” test.

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SECOND CIRCUIT SECTION 16 DECISION CREATES UNCERTAINTIES FOR DEEMED INSIDERS IN SOME “GROUP” SITUATIONS

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JENNINGS SHOULD BE OF SPECIFIC INTEREST TO PERSONS WHO FORM GROUPS TO POTENTIALLY ACQUIRE CONTROL OF A PUBLIC COMPANY, THE CONTEXT IN WHICH THE CASE ACTUALLY AROSE

A recent decision of the Second Circuit Court of Appeals, *Roth v. Jennings*, 2007 WL 1629889 (CA-2, June 6, 2007), creates potentially significant new uncertainties for persons who may be deemed insiders for purposes of the short-swing liability provisions of section 16 of the Securities Exchange Act of 1934, as amended (“Act”), by being part of a “group” within the meaning of section 13(d) of the Act. The decision vacates a ruling of the District Court for the Southern District of New York (2006 WL 1629889 (DC N.Y., 2006)) that dismissed a shareholder’s suit under section 16 for disgorgement of short-swing profits. The specific legal interpretation on which the decision turns

had not previously been decided in a published opinion.

The case involves two persons—T. Benjamin Jennings (“Jennings”) and European Metal Recycling, Ltd. (EMR)—who were presumed to constitute a group at the time that Jennings purchased securities of Metal Management Inc. (MMI). When the purchase was made, Jennings and EMR together beneficially owned more than 10% of the MMI stock. Jennings subsequently sold MMI stock at a profit within six months of the purchase, when he individually beneficially owned less than 10% of MMI’s stock. The Second Circuit held as a matter of law that, for purposes of determining whether Jennings was liable for short-swing profits under section 16 as a result of his sales of MMI stock, it was irrelevant whether Jennings and EMR continued to constitute a group at the time of the sales. In an alternative holding, the circuit court also stated that the district court’s determination that Jennings and EMR ceased to constitute a group

at the time of the sales was, in the context of a motion to dismiss, improper as a procedural matter.

FACTS

In May 2003, Jennings, the former Chairman and CEO of MMI, purchased shares of MMI stock representing 8.3% of MMI’s outstanding stock with an unsecured \$10 million loan from EMR, a company that owned at that time 14.3% of MMI’s outstanding stock. On September 8, 2003, EMR and MMI signed a standstill agreement stipulating that EMR would not buy additional MMI shares, or sell its MMI holdings, until the companies explored a potential business combination. In the meantime, between July 14 and September 9, 2003, Jennings sold the majority of his MMI shares at a profit of approximately \$4.25 million.

Roth brought a shareholder derivative action against Jennings and MMI for disgorgement of profits from Jennings’ short-swing transactions, alleging that although Jennings