



# State of Utah

## DEPARTMENT OF COMMERCE DIVISION OF SECURITIES

*Protecting Investors; Promoting Commerce*

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May 24, 2001

Mr. Steven M. Prebish  
Patzik, Frank & Samotny Ltd.  
150 South Wacker Drive Suite 900  
Chicago, IL 60606

Re: TruServ Corporation  
*File # B00265525*

Dear Mr. Prebish:

Pursuant to your letter dated May 10, 2001, the Utah Division of Securities ("Division") has reviewed your no-action request pursuant to § 61-1-25(5) of the Utah Uniform Securities Act ("Act") and § R164-25-5 of the Utah Administrative Code.

Please be advised that based upon the facts presented, and in reliance upon your opinion as counsel, the Division staff will not recommend any enforcement or administrative action should the transaction proceed as outlined in your request. To avoid unnecessary restatement or summarization of the facts set forth in your request, a copy of your May 10, 2001, letter is attached.

This response does not purport to express any legal conclusions regarding the applicability of statutory or regulatory provisions of federal or state securities laws to the question presented. It merely expresses the Division's position on enforcement or other administrative actions.

Since this no-action letter is based upon the representations made to the Division, it should be noted that any different facts or conditions of a material nature might require a different conclusion. Furthermore, this no-action letter relates only to the applicant and shall have no value for future similar events. Nor does this letter absolve any party involved from complying with the anti-fraud provisions contained in § 61-1-1 of the Act.

Very truly yours,

UTAH DIVISION OF SECURITIES

Joel Nelson  
Director of Corporate Finance

Attachment

LAW OFFICES

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May 10, 2001

2839-006

**VIA CERTIFIED MAIL  
RETURN RECEIPT REQUESTED**

Mr. S. Anthony Taggart  
Director  
Securities Division  
160 East 300 South  
Second Floor  
Salt Lake City, UT 84114-6760

**RE: TRUSERV CORPORATION NO ACTION REQUEST**

Dear Mr. Taggart:

This firm has recently been retained by TruServ Corporation, the cooperative wholesale distributor for True Value, ServiStar and Coast to Coast hardware, paint and lumber stores (the "**Company**"), to assist the Company in connection with certain securities law issues. In that regard, on behalf of the Company, we hereby respectfully request that the Securities Division issue a NO-ACTION LETTER, or similar interpretive opinion, determining that neither the Company's Class A Common Stock nor the Company's Class B Common Stock is a "security" within the meaning of Section 61-1-13 of the Utah Code Annotated (the "**Act**"). We recognize that you may have received a similar request to this end from the Company in or around 1998 and granted interpretive relief; however, that request related only to the Company's Class A Common Stock. Thus, we are submitting this request to include both the Class A Common Stock and the Class B Common Stock. The Company's structure has not changed since the Company last requested interpretive relief but is reiterated as follows for your convenience:

**STATEMENT OF FACTS**

Since its inception in 1948, the Company has conducted business as a cooperative buying association for the benefit of its Members (as hereinafter defined). As of December 31, 2000, the Company had over 8,000 Members doing business in all 50 states and in several foreign countries. The Company is one of the largest hardware cooperative distributors in the world.

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All holders of the Company's Class A Common Stock (the "**Class A Shares**") are individuals, partnerships, corporations, or limited liability companies who sell hardware, lumber or builders' supplies at retail or are in the equipment rental business (the "**Members**"). Ownership of Class A Shares is expressly limited to such retailers and renters (together, "**retailers**"). Each Member holds 60 or more Class A Shares, with a par value of \$100.00 per share. The Company requires each Member to purchase one unit of 60 Class A Shares (at \$6,000) for each of the first five retail establishments owned by the Member. Thus, each Member is required to purchase a minimum of 60 (\$6,000) and a maximum of 300 (\$30,000) Class A Shares. No Member may own more than 300 Class A Shares, regardless of the number of retail locations operated by the Member. Members of the Company presently operate approximately 8,000 retail or rental storcs.

Purchase of the Class A Shares is an incident to Membership in the Company. Proceeds from the sale of Class A Shares provide necessary working capital for the Company, helping to fund the purchase of inventories of goods and merchandise needed to supply the Members, and to support the general operation of the Company.

The "securities" offered for sale upon Membership in the Company are authorized but unissued Class A Shares of the Company, and will be issued at par, and sold for \$100.00 per share.

The Company engages in mass purchasing from approximately 5,105 different sources. The Company operates 23 warehouses which are located in Hagarstown, Maryland; Jonesboro (Atlanta), Georgia; Springfield, Oregon; Woodland, California; Kingman, Arizona; Brookings, South Dakota; Mankato, Minnesota; Kansas City, Missouri; Henderson, North Carolina; Denver, Colorado; Corsicana, Texas; Harvard, Illinois; East Butler, Pennsylvania; Westlake (Cleveland), Ohio; Allentown, Pennsylvania; Westfield, Massachusetts and Manchester, New Hampshire. Each warehouse stocks nearly 80,000 different line items of merchandise for the Company Members. The merchandise is delivered to the Members by private trucks on weekly scheduled routes.

The Company, based upon the volume of, and the margins applicable to merchandise and services purchased by any given Member during a given year, pays Members a yearly "patronage dividend" out of the revenues from business done with or for that Member after deducting expenses, taxes, bad debt, casualty losses, and reasonable reserves of working capital necessary for the operation of the Company. The Company does not pay "dividends" in the usual sense. Only patronage dividends are distributed to Members, based on patronage with the Company and not on shareholdings.

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The Company has the right to, and does, pay a portion of the patronage dividends in the form of Class B Common Stock (the "**Class B Shares**"). The attributes of the Class B Shares are identical in all respects to the Class A Shares except that the Class B Shares are non-voting.

Due to a number of resale restrictions in the Company's Certificate of Incorporation and By-Laws, as well as the Company's historical practice of not permitting a transfer to a non-retailer, it is for all intents and purposes impossible for the Company's Class A Shares or Class B Shares (together, the "**Shares**") to be transferred to non-Members. Upon ceasing to be a Member of the Company, the ex-Member's Class A and Class B Shares must be re-sold to the Company and the Company is obligated to repurchase such ex-Member's Shares. The price at which the Shares are repurchased is equal to their par value, or \$100 per Share. Thus, there is no appreciation in the value of the Shares. In addition, the outstanding Shares are subject to a security interest of the Company to secure the payment of any indebtedness due to the Company from a Member, thereby further encumbering their transferability.

The Company's Class A and Class B Shares are not listed on any stock exchange nor traded on the NASDAQ system. Thus, there is *no secondary market* for the Company's Shares. The Company Share repurchases are subject only to legal limitations for protection of the Company's financial condition.

## ARGUMENT

### I. COMPANY CLASS A "SHARES" ARE NOT A "SECURITY" SUBJECT TO REGISTRATION

At issue first is whether the Class A Shares which each customer of the Company is required to purchase for Membership in the Company, are in fact, "securities" under the Act. Section 61-1-13 of the Act defines a "security" as follows:

"(24) (a) "Security" means any:

- (i) note;
- (ii) stock;
- (iii) treasury stock;
- (iv) bond;
- (v) debenture;

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(xviii) in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

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(b) "Security" does not include any:

(i) insurance or endowment policy or annuity contract under which an insurance company promises to pay money in a lump sum or periodically for life or some other specified period; or

(ii) interest in a limited liability company in which the limited liability company is formed as part of an estate plan where all of the members are related by blood or marriage, there are five or fewer members, or the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company. Evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company."

While the statute defines "security" in sufficiently broad terms to include within its definition the vast variety of instruments that in the course of commercial activity fall within the ordinary concept of "security," it is also true that courts have recognized that "Congress never intended the securities laws to apply to all sales; otherwise the detailed reporting provisions and other requirements would seriously clog everyday commerce." *Van Huss v. Associated Milk Producers, Inc.*, 415 F.Supp. 356 (N.D. Tex. 1976).

In the text of the Securities Act of 1933, within which the issue is most frequently considered, are the identical phrases of Section 2(1) of that Act: "...certificate of interest or participation in any profit-sharing agreement" or "investment contract." The fundamental premise of an investment contract is that a person is induced to part with money with the expectation that he or she will obtain "profits" by virtue of the investment. As stated in *SEC v. W.J. Howey Company*, 328 U.S. 293 (1946):

*"The test is whether the scheme involves an investment of money in a common enterprise with profits to be derived from the entrepreneurial or management efforts of others."*

Similarly, the Supreme Court has placed heavy emphasis in subsequent cases on the need for the *profit expectation*, notwithstanding the fact that ownership interests in cooperatives do, by a strict reading of the statute, resemble securities. The Court was clearly stating that form should be disregarded for substance and that the emphasis should be on economic reality when determining whether an instrument is, in fact, a security.

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The Company submits that a Member of the cooperative, being a customer of the Company, views the mandatory purchase of Class A "Shares" as a necessary incident to doing business with the cooperative and not in any way related to an initial "investment" which is expected to generate income. Members expect a return from their own labors, and from their purchases of merchandise from the cooperative, not from their investment of capital in Class A Shares. This position appears to be well accepted in both judicial decisions and no-action interpretations.

In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), the Supreme Court held that the share of common stock which entitled the purchaser to lease an apartment in a New York State subsidized non-profit cooperative housing project did not constitute a "security" within the meaning of the federal 1933 and 1934 Acts. In reversing a prior decision by the U.S. Court of Appeals (the Second Circuit), which held that because the instruments were labeled "stock", the definition section (2(1)) of the 1933 Act applied, the Court said:

*"We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock", must be considered a security transaction simply because the statutory definition of a security includes the words 'any...stock'. Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock." (emphasis added).*

The relationship between Members and the Company, is in many respects similar to the relationship in *Forman* between the housing cooperative and its stockholder-tenants. First, in *Forman*, the tenants could not transfer, assign or pledge their common stock. As stated previously, there is no secondary market for the Member's Class A Shares. The Company repurchases all Shares at the behest of the Member.

Second, in the housing cooperative case, the tenants who desired to sell their shares were required to offer the stock to the housing co-op at its initial issue price. Similarly, the Company's Certificate of Incorporation and By-Laws require that when the Company repurchases the shares of any terminating Member it repurchases them at their par value, or \$100 per share, which is the price paid for them by the Members (less any allocations of loss spread among Members or amounts owed the Company by the terminating Member). Thus, there is no opportunity for a Member of the Company to realize any gain from the sale of the Shares due to appreciation in value.

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A third and striking similarity between the housing cooperative and its tenant Members and the Company and its Members is that under the housing arrangement, the tenants purchased the stock for the economic benefit of subsidized low-cost housing and not with the expectation of making a profit. Likewise, hardware, home center, and lumber retailers seek Membership in the Company in order to realize reduced merchandise costs by purchasing inventory and services collectively in large volume which results in an economic benefit to them. That benefit, however, is not tantamount to a "profit" relating to purchase of a security because the price of the security itself does not appreciate and profits depend solely on the individual Member's own hard work, and business acumen.

In an identical case, but involving a private cooperative housing arrangement, rather than public, the Second Circuit applied the economic realty test enunciated in *Forman* and found that the membership instruments were not an "investment security" as defined in the 1933 and 1934 Acts, and therefore not a proper subject for registration. The fact that *Forman* involved a public entity and not a private concern was deemed to be of no significance.

The critical distinction between the Company and business corporations whose securities must be registered lies in the fact that financial benefits which accrue to the Members of the Company are directly related to their *patronage activity*, (i.e. the amount and type of their purchases from the Company) while the financial benefits of a business corporation are returned to shareholders in direct proportion to their investment in that corporation. Additionally, business corporations' securities pay-out based upon the success of the corporation rather than the individual. The Company does not operate to produce profits, but like other cooperatives, conducts its business on a cost basis and returns to its Members in the form of patronage dividends any excess of receipts over expenses. These are not "profits" within the meaning of federal and state securities laws. A true security associated with a business corporation, on the other hand, enjoys the opportunity for potential gain or profit. The profit referred to is either capital appreciation resulting from the initial investment, or participation in earnings resulting from the use of the investors' funds. Clearly, a retailer's decision to associate with the Company is not predicated on a chance to realize some investment gain, but rather is the result of critical evaluation of the economic benefits of lower cost for merchandise through cooperative buying and distributing.

In the present case, the benefits derived from ownership of the Company's Class A Shares result almost exclusively from the managerial efforts of the owner of the retail establishment, not the Company. The Members of the Company succeed or fail on the basis of their own business acumen. Although it is true that patronage dividends can increase or decrease based upon the Company's overall margins, the patronage dividends, which may include Class B Shares, are actually a reduction in purchase price for the hardware good merchandise purchased during the previous year. Of course, no patronage dividends would be paid to an owner of Shares who purchased no merchandise from the Company.

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The Company's Class A Shares are not properly thought of as securities. The buyers of the Shares are not motivated by the profit the Shares are expected to generate, as the possibility of a patronage dividend payable on the Shares generates no profits for the holders, merely purchase rebates. Further, the Company only sells sixty (60) shares per Member store location, up to a maximum of five retail locations and, therefore, a corresponding maximum of 300 Class A Shares per Member; no one is allowed to "invest" extra money in the Company through purchasing additional Class A Shares because such "investing" would be without return, as the Company pays no interest or share-proportional dividends.

The Company's shares are not publicly traded and thus, no market exists. Only hardware retailers may own the shares. Members do not purchase the Common Shares as a speculative investment. Membership in the Company is limited to hardware retailers who qualify for Membership; the public may not purchase the Company's Class A Shares. The expectations of the retailers who purchase the shares involve solely the prospect of buying goods and services from the Company.

All sales of the Company's Class A Shares are made as follows: (i) a prospectus is provided to a potential member (as explained herein, the Company has historically prepared offering materials compliant with the Securities Act of 1933, as amended) (the "**Securities Act**") along with a member sign-up package (including a subscription agreement); and (ii) then questions are fielded by a department of employees trained to respond. No oral solicitations are made and no outside underwriters or broker-dealers are employed. The Company employees receive no compensation or commission from the sale of Shares in the Company. Sales of Class A Shares are merely an incident to Membership in the cooperative and are effected only after the Company has approved the applicant for Membership in the Company. The Class A Shares are not sold to the investing public; the Company requires the Class A Shares to be purchased by prospective Members who are hardware retailers.

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Generally speaking, the registration requirements of both the federal and state securities laws are aimed primarily at disclosure of information needed to determine whether to make an investment by looking at such factors as prospective yield and appreciation. The Company's prospective Members gather their information about whether to join a cooperative corporation from trade and business needs. The Company's Members must make business judgments regarding the availability and cost of merchandise and services based upon competitive pricing and availability in the market place. They do not require an offering circular in the form prescribed by the Securities Act or the Act to make an informed judgment on such matters. In fact, the offering circular provides little, if any, help to a retailer in making the basic business decisions on whether to "join" the Company. Nevertheless, the Company has historically disclosed and unless and until the Securities and Exchange Commission ("SEC") grants similar interpretive relief, will continue to disclose information through filing with the SEC. The Company is in the process of seeking such relief.

The financial burdens of registration and compliance with agent registrations are substantial. The internal and outside expenses of legal counsel, independent accountants, and printing total thousands of dollars per year. This added cost of doing business for the Company and its Members must be paid out of the margins normally distributed by the Company to the Members as patronage dividends.

Additionally, the time and money spent complying with state securities registrations and exemptions in all states in which the Company has Members and the surplusage contained in the Members solicitation materials as it relates to securities laws can be costly, awkward, and essentially distracting from the subject of providing retailers with a better source for services and merchandise to help them, as Members of the cooperative group, to make more profit as retailers and to better serve retail customers.

## **II. Company Class B "Shares" Are Not a "Security" Subject to Registration**

The Class B Shares are identical to the Class A Shares in all respects except that the Class B Shares are non-voting. This ensures that even if one Member purchases substantially more goods from the Company resulting in a larger patronage dividend than other Members, the voting power of the Company's Members will not change. Additionally, the Class B Shares are not "offered" or "sold" to anyone but rather are issued automatically in amounts proportionate to a Member's purchases from the Company as a portion of that Member's annual "patronage dividend." The Class B Shares cannot be purchased. Additionally, the SEC has also expressed its opinion, at the Company's request, that the Class B Shares are not securities subject to registration under the Securities Act. Accordingly, the Company submits that the Class B Shares possess even fewer of the traditional characteristics of a "security" than do the Class A Shares and, therefore, the Company reiterates the argument for Class A Shares set forth above in

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concluding that the Class B shares do not constitute "securities" within the meaning of the statute and regulations.

## CONCLUSION

From the foregoing, it is clear that the Class A "Shares" of the Company, which hardware, lumber and building materials retailers are required to purchase to become "Members," and the Class B "Shares" issued on account of an individual Member's patronage, lack the characteristics of an investment security, are required and distributed merely as an incident of Membership in the Company, have no marketability, and are not the type of instrument which the securities laws were designed to regulate. We, therefore, respectfully request that an appropriate no-action letter which declares that the Class A and Class B "Shares" issued by the Company are not securities within the meaning of Section 61-1-13 of the Act.

For your reference, we direct your attention to the following no-action letters, copies of which are enclosed herewith, for the numerous near identical instances in which no-action relief has been granted:

- 1) Hardware Wholesalers, Inc.
- 2) Our Own Hardware Co.
- 3) American Hardware Supply Company (which, coincidentally, was a hardware cooperative which merged into the Company in 1997)
- 4) Ace Hardware
- 5) Veterinary Products, Inc.

Enclosed is a check in the amount of \$120.00 to cover the required fee.

Please do not hesitate to contact me with any questions or concerns regarding the above request.

Respectfully submitted,

**PATZIK, FRANK & SAMOTNY LTD.**



Steven M. Prebish

SMP:dlj