ADMINISTRATIVE PROCEEDING
FILE NO. 3-4587

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
ALL AMERICAN BURGER, INC.
(24SF-3932)

INITIAL DECISION

June 30, 1975
Washington, D.C.

Ralph Hunter Tracy
Administrative Law Judge

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APPEARANCES: David P. Goss, Carl Noelke and Ralph A. Cotton, Staff Attorneys of the San Francisco Branch Office, for the Division of Corporation Finance of the Commission.

William F. Rinehart and Zoltan A. Harasty of MacDonald, Halsted and Laybourne, Los Angeles, California, for All American Burger, Inc.

BEFORE: Ralph Hunter Tracy, Administrative Law Judge

All American Burger Inc., (All American), incorporated in California on August 23, 1968, filed with the Commission on August 7, 1972, a Notification and Offering Circular for the purpose of obtaining an exemption from the registration requirements of the Securities Act of 1933 (Securities Act) pursuant to Section 3(b) thereof and Regulation A thereunder, with respect to a public offering of 125,000 shares of its $0.10 par value common stock at $4.00 per share. Subsequent amendments filed on September 23, 1972 and October 24, 1972, reduced the proposed offering to 80,000 shares at $3.00 per share. According to a report filed by All American on Form 2-A on April 27, 1973, the offering commenced on October 31, 1972 and was completed on December 29, 1972, with 80,000 shares being sold at $3.00 a share for a total of $240,000. Daniel Reeves & Co., a registered broker-dealer with offices at 1090 Wilshire Boulevard, Los Angeles, California, was named as underwriter of the offering.

The Commission, on November 21, 1974, issued an Order (Order) pursuant to Rule 261 of Regulation A temporarily suspending the exemption. The Order alleges, in substance, that the Notification and Offering Circular contain untrue statements of material facts and omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, particularly with respect to the inclusion in its financial

statements of $50,000 received from the sale of a franchise; the failure to disclose the existence of a written agreement which prevented the issuer from using the money and the failure to disclose that full payment of the franchise fee was contingent upon successful completion of the Regulation A offering.

All American (sometimes hereafter referred to as the issuer) filed an answer denying the allegations and requesting a hearing to determine whether the Order should be vacated or the suspension of the exemption made permanent.

The hearing was held at Los Angeles, California, and the issuer was represented by counsel. Proposed findings of fact and conclusions of law and briefs in support were filed by the parties.

The findings and conclusions herein are based upon the record and upon observation of the witnesses.

All American was organized as a California corporation on August 23, 1968, to operate a chain of "fast foods" restaurants in the Los Angeles area. The president Aaron M. Binder (Binder) and the vice-president and secretary-treasurer Eli S. Passy (Passy) had formerly operated a fast foods facility under the name of "Handy's Hamburgers" at one location. At the time of the offering the company had five All American restaurants operating in the Los Angeles area including four owned and operated by it and one owned and operated by a franchise from which the company received no income.

All of the issues in this proceeding flow from the sale of an area franchise by issuer to Duran Gauge Company owned by Joseph M. Duran (Duran) for $50,000 with a down payment of $10,000 and a non-interest bearing note of $40,000. The franchise sale took place on February 29, 1972, and a multiple franchise agreement was signed by Binder, as president of issuer, and by Duran as franchisee. On August 7, 1972, issuer filed a Notification and Offering Circular with the Commission pursuant to Regulation A. The financial statements filed as part of the Offering Circular contained an audited balance sheet and a related statement of operations for the fiscal year ended August 31, 1971, and an unaudited balance sheet and related statement of operations for the ten months ended June 30, 1972. Issuers' independent accountant was Alexander Grant & Company (Grant).

Although the Notification and Offering Circular was amended on September 28 and October 24, 1972, the statement of operations was not amended and the Circular used in the offering, dated October 31, 1972, contained the statement of operations as originally filed.

In its Offering Circular, under Operating Results, issuer states that as of June 30, 1972, its retained earnings deficit was $149,718; that it has not made a net profit since its incorporation and that it sustained a net loss of $13,601 for the 10-month period ending June 30, 1972. It is stated, also, that during this 10-month period the Company had income of $50,000 from the sale of an area franchise without which its net loss for the period was $63,601.

In the Offering Circular, under Franchises Offered, the issuer states that prior to 1972 it had devoted little effort to the sale of its franchises; that during 1971 it resolved to establish additional franchise-operated stores; that it intends to seek to franchise ten additional locations and that during February 1972 it sold its first area franchise. It goes on to say that it proposes to devote increasing efforts to the sale of franchises but the Company cannot guarantee success with respect to its current and proposed efforts at franchising.

All American, in its Statement of Operations for the ten months ended June 30, 1972, shows revenue from Franchise sales (note A) of $50,000 and an operating profit for the period of $14,663. The overall net earnings for the period show a loss of $13,601. Note A - History and Treatment of Franchise Revenues, states that as of February 29, 1972, the company sold its first area franchise for $50,000 receiving therefor $10,000 in cash and a demand note of $40,000, and that the note was collected subsequent to June 30, 1972. Note A further states that the company records income on the sale of franchises when substantially all of its obligations have been performed (see note D).

Note D - Other Assets states, that the first franchise of the new program was sold February 29, 1972; all significant costs and expenses of the franchise sale have been charged to expense as of June 30, 1972 (see note A)..

At the commencement of the proceeding All American and the Division entered into the following stipulation of fact which was received in evidence:

1. On August 7, 1972, All American filed a Notification and Offering Circular with the San Francisco Branch Office pursuant to Regulation A of the General Rules and Regulations under the Securities Act of 1933, as amended, File No. 24SF-3932.

2. All American's Offering Circular contained financial statements audited by Alexander Grant & Co. (Grant) for the year ending August 31, 1971.

3. The Offering Circular also contained unaudited financial statements for the 10 months ending June 30, 1972. All American's Statement of Operations for the 10 month period ending June 30, 1972 included as Revenue $50,000 from the sale of the franchise to Duran.

4. As of August 7, 1972, the date All American Notification and Offering Circular were filed, the $40,000 promissory note from Duran was unpaid.

5. In about September, 1972, Grant recommended that All American collect the $40,000 promissory note.

6. With the $40,000 check, All American purchased a Time Certificate of Deposit (TCD) from the Imperial Bank of Torrance in the amount of $40,000 on September 25, 1972.

7. On September 25, 1972, escrow account T-980 was opened at the Imperial Bank By Binder, Passy and Duran. All American's TCD for $40,000 which had just been purchased with the check from Duran, was placed in this escrow account. The TCD could not be released from this escrow account without a signed authorization from Binder, Passy and Duran. After January 1, 1973, the TCD could be released from escrow only by the signed authorization of Joseph Duran.

8. By letter, received by Grant on September 26, 1972, All American confirmed to Grant that Duran had paid the $40,000 demand note. The letter did not disclose to Grant that the TCD purchased with the proceeds received from Duran was being held in escrow at the Imperial Bank. All American did not deliver to Grant a copy of the September 25, 1972 agreement.

9. All American commenced its offering pursuant to Regulation A on October 31, 1972.

10. All American's Offering Circular did not disclose that the TCD purchased with the proceeds of the promissory note was placed in an escrow account from which it could be released up to January 1, 1973, only with the authorization of Messrs. Binder, Passy and Duran and after January 1, 1973, only with the authorization of Duran.

11. Interest which accrued on All American's TCD held in escrow was paid to Duran.

12. On April 30, 1973, All American filed a report on Form 2-A which stated that the offering ended on December 29, 1973 with all 80,000 shares offered, sold.

13. On January 16, 1973, Joseph Duran authorized the release from escrow of the All American TCD which was converted into a cashier's check payable to All American in the amount of $40,000.

The agreement referred to in paragraph 8 above was between Binder and Passy and Duran Gauge Co., referred to as "the Corporation," and stated, in pertinent part: "In the event that the entire issuance (underwriting) is not sold by January 1, 1973, Passy and Binder, in their capacity as officers, directors and shareholders of All American will take such action, through All American, as may be necessary to cause All American to return said $50,000 to the Corporation, and in the event said underwriting is not sold in full by January 1, 1973, and All American fails to return said $50,000 to the Corporation, Binder and Passy personally, jointly and severally, as individuals, guarantee the payment of the indebtedness ($50,000) as herein agreed upon."

As can be seen from the stipulation the facts in this matter are not in dispute. As stated by respondent's counsel at the hearing and repeated in his brief respondent's position simply is that the omissions which admittedly occurred were not material; that the accounting treatment was proper; and that public interest and protection of investors do not require permanent suspension of issuer's Regulation A exemption.

In connection with its review of issuer's June 30, 1972, financial statements in the Offering Circular, Grant became concerned that Duran's

demand note was in fact uncollected although the $50,000 franchise fee was being carried as revenue with the representation that all obligations in connection with the sale of the franchise had been substantially peformed. (Note A of financial statement - see supra, page 3). Accordingly, Grant informed All American that unless the $40,000 note was collected the $50,000 franchise fee would have to be deleted from earnings. Otherwise, Grant would refuse to permit its name to be associated with the financial statements in issuer's Offering Circular.

Upon receipt of this "ultimatum" from Grant, Binder requested Duran to pay the note which he agreed to do only upon receiving certain guarantees which were embodied in the agreement of September 25, 1972. (Page 6, supra). Upon execution of the agreement, Duran paid the note with a $40,000 check which was used to purchase a TCD in Issuers' name although it was placed in an escrow account from which it could be released only with the consent of Duran who, also, received the interest payments on the TCD.

In an undated letter which Grant received on September 26, 1972, Binder stated: a. "Mr. Duran has paid his demand note to us in full on September 25, 1972; and, in connection therewith, the company has incurred no guarantees or other obligations.

* * *

d. We have no agreements or contracts with or obligations to Mr. Duran other than those included in the February 29 and August 4, 1972 area franchise agreements."

ISSUES

Respondent argues that the ultimate and fundamental issue in this case is whether it is in the public interest at this time to permanently suspend All American's Regulation A exemption and that to resolve this issue, two other basic issues must be resolved:

1. Were the omissions and/or alleged misrepresentations material?

2. Were the financial statements contained in the offering circular prepared in accordance with then applicable generally accepted accounting principles?

MATERIALITY OF OMISSIONS

Respondent bases its argument that the omissions concerning the restrictions placed on the use of the $50,000 franchise fee by the agreement between Issuer and Duran to return the fee if the offering was not completed, and the placing of the $40,000 payment in an escrow account under Duran's control were not material, on the fact the All American did receive the $50,000 franchise fee, did use it in the manner intended and the shareholders did receive the full benefit of it. Issuer argues that the Division's brief is replete with technical discussions of disclosure and accounting matters but does not cite one instance where any shareholder claims to have been misled.

Respondent disputes the Division's position that because the escrow and guarantee agreement had not been disclosed, an investor could come to the conclusion that the franchises were readily saleable and would continue to be a source of income to Issuer, and that therefore

this was a material nondisclosure. Issuer argues that it specifically disclosed that additonal sales of franchises could not be depended upon to produce future earnings and points to page 3 of the Offering Circular where it states: "There is no assurance that other area franchises may be sold by the Company." Furthermore, at page 9, under "Franchises Offered", the Offering Circular states:

> "To date only this one additional franchise has been sold. The company proposes to devote increasing efforts to the sale of franchises but the Company cannot guarantee success with respect to its current and proposed efforts at franchising."

Thus, respondent urges, a prospective investor had been specifically put on notice that no other area franchise might be sold and there is nothing else in the Offering Circular which contradicts the cited statements. Any contrary inferences made by any prospective investor are not warranted by the express language of the Offering Circular.

Also, the Offering Circular is replete with information concerning the poor financial condition of All American: " . . . retained earnings deficit . . . of $149,718," ". . . not made a profit since the date of its incorporation . . .," "net loss before franchise sales . . . of $63,601." (page 3).

Respondent goes on to point out that on page 11 of the Offering Circular disclosure is made that Binder and Passy have personally guaranteed certain of the Company's indebtedness and that Mr. Binder has also guaranteed substantially all of the long-term indebtedness of the Company. The Offering Circular also contains information in the

last paragraph of the cover that makes it clear that there is a possibility that the offering might not close.

Therefore, respondent contends, by reading the Offering Circular (including the statement on the cover that "THIS OFFERING INVOLVES A HIGH DEGREE OF RISK") a reasonable investor would be adequately informed of the poor financial condition of All American. Such investor would be informed: (1) that Binder and Passy made personal guarantees for the benefit of All American, (2) that by clear and specific notice, there might be no future sales of franchises, and (3) that the offering might not close.

Respondent concludes its materiality argument by stating that with benefit of hindsight it does not dispute that it would have been preferable to have included references to the guarantee and escrow in the Offering Circular. It does dispute, in light of the disclosures actually made in the Offering Circular, the Division's contentions that the omissions were material.

The explanations in the Offering Circular relied on by respondent do not cure the omissions, especially where, as under Operating Results on page 3, the income from the franchise sale is described as having been received when in fact it had not. It is irrelevant that no investor testified as to having been misled. As the court said in Affiliated Ute Citizens v. United States, 406 U.S. 128 at 153:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision. (Citations omitted).

In addition, both of the accountants who were qualified as experts, one for the Division and one for the respondent, testified that the Offering Circular should have disclosed the existence of the guarantee agreement.

It is found that the failure to disclose the guarantee agreement, the escrow agreement and the contingent obligation to refund the franchise fee were material omissions of fact. 1/

FINANCIAL STATEMENTS

The Order alleges that the financial statements filed with All American's Offering Circular were not prepared in accordance with generally accepted accounting principles. This is based on the premise that because of the restrictions and contingencies placed on the payment and use of the $50,000 franchise fee it could not be considered as income and should have been deleted from the statement of operations for the period ended June 30, 1972.

The accounting firm of Alexander Grant & Co. (Grant), which was All American's accountant, told All American to either collect the note from Duran or delete it from its earnings (page 8, supra). On September 26, 1972, Grant received a letter from Binder saying that Duran had paid the demand note in full on September 25, 1972. However, Grant was not told of the agreement preventing the use of this money by All American or of the escrow arrangement. On January 15, 1973, All American prepared a letter to Grant for Duran to sign which said, in paragraph 5, that the $40,000 note had been paid and the proceeds put

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1/ See, Major Realty Corporation, 44 S.E.C. 535 (1971); Performance Systems, Inc., 44 S.E.C. 750, (1971).

into a TCD in All American's name. By letter of January 16, 1973, All American requested the Imperial Bank to confirm to Grant that the TCD was unrestricted as to its use by All American at August 31, 1972, and as of the date of this confirmation. As a matter of fact the TCD was not released until after the completion of the offering in January 1973.

On October 26, 1973, Grant wrote to Binder at All American informing him that it was withdrawing its certification of All American's financial statements for its fiscal year ended August 31, 1972, and their consent regarding financial statements appearing in All American's Offering Circular dated October 31, 1972. Grant's reason for its withdrawal was that the $50,000 reported as income from the sale of a franchise should not have been included in income because of the agreement of September 25, 1972, executed by Binder, Passy and Duran, which Grant stated it only learned of on October 22, 1973.

This letter from Grant was followed on November 2, 1973, by a press release by All American, apparently prepared by Grant with the approval of the San Francisco Branch Office of the SEC. While setting forth the gist of the Grant letter it also stated that in the opinion of the Company the agreement of September 25, 1972, did not create any obligation on the part of the Company and hence it was proper for the $50,000 to be included in income for the periods reported upon.

During the late sixties a number of registrations concerning franchise fees were filed with the Commission. As no clear accounting standards for franchise fee revenue then existed the Commission and the accounting profession met to formulate guidelines in this area. These guidelines were then published in an article by Archibald McKay in the Journal of Accountancy for January 1970 and have been accepted and followed by the accounting profession generally. They were further enuciated by the Commission in Performance Systems, Inc., 44 S.E.C. 750 (1971).

The thrust of the McKay article was that " . . . the initial franchise fee should not be recognized as revenue until both the franchisor and franchisee have substantially performed their obligations under the agreement or under industry or company practice, as appropriate in the circumstances." Clearly, under this test for the recognition of franchise fee income, as followed by the Commission in Performance Systems, Inc., the recognition by All American of the Duran franchise fee before either side had performed their obligations was inappropriate and not in accordance with generally accepted accounting principles.

All American advances the argument that while the McKay article appeared in January 1970 and the decision in Performance Systems, Inc., was rendered in December 1971, it was not until December 1972, that the American Institute of Certified Public Accountants (AICPA) published its accounting entitled "Accounting for Franchise Fee Revenue." Issuer takes

the position that the AICPA guideline refutes the Division's position that the McKay article itself fixed generally accepted accounting principles with respect to franchise fees and submits that its June 30, 1972, financial statements were prepared using practices generally accepted prior to December 1972, and therefore, such statements were prepared in accordance with generally accepted accounting principles as they existed at the time the statements were prepared and published.

A reading of the McKay article refutes the idea that it established any new accounting principles. It says that it will deal with economic realties that should be reflected in the financial statements and, on page 68, quotes Accounting Research Bulletin (ARB) No. 43, Chapter 1A, paragraph 1:

> "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sales price is not reasonably assured. See Montgomery's Auditing (8th Ed.) page 438; Accounting Series Release 95." (Emphasis supplied)

Following further discussion McKay says in conclusion, at page 72:

> "No new principles are suggested here; what is suggested is the application of existing principles to traditional accounting problems that have been aggravated by the dramatic, explosive growth of a new industry."

Accounting Series Release No. 95, referred to by McKay, was published by the Commission on December 28, 1962, and issued as Securities Exchange Act Release No. 6982. It is entitled Accounting for Real Estate Transactions Where Circumstances Indicate the Profits were not Earned

at the Time the Transactions were Recorded. It says, in pertinent part:

> "The recognition of profit at the time of sale, in accordance with generally accepted accounting principles, is appropriate if it is reasonable to conclude, in the light of all the circumstances, that a profit has been realized."

It then quotes the same paragraph from ARB No. 43 as the McKay article and continues:

> "Thus, recognition of profit is appropriate only when a bona fide sales transaction has taken place, and then only to the extent that the consideration received in the transaction can be reasonably evaluated."

It is found that the financial statements used by All American were not prepared in accordance with generally accepted accounting principles as required by Item 11 of Schedule I of Form 1-A.

SECTION 17(a) of the SECURITIES ACT

As found above, the Offering Circular used by All American in its offering contains untrue statements of material facts and omits to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, particularly with respect to the financial statements which, also, have been found not to have been prepared in accordance with generally accepted accounting principles. Accordingly, the use of the Offering Circular in connection with All American's offering of its common stock operated as a fraud and deceit upon purchasers in violation of Section 17(a) of the Securities Act.

CONCLUSION

Respondent's arguments in support of the inclusion of the $50,000 in income are really arguments in favor of form over substance. The transaction with Duran had not been completed, it was based on the success of the offering. As a matter of economic reality it was a bootstrap operation. All American needed the $50,000 but in order to get it the offering had to be completed; in order to help sell the offering the $50,000 would look good in the Offering Circular; this would influence investors to buy the stock which would be a contributing factor in completing the offering and, thus, validate the financial statement. Respondent's comment that the offering was completed and the $50,000 received so that no one was hurt is merely another way of saying that investors were being misled to their benefit. This line of reasoning is rejected.

It is axiomatic that the burden of establishing the availability of an exemption from registration rests upon the one who claims it.[2/] "The exemption afforded by Regulation A is a conditional one based on compliance with express conditions and standards, and Rule 261 specifically provides that we may suspend an exemption in the event of non-compliance."[3/]

IT IS ORDERED, pursuant to Rule 261 of Regulation A under the Securities Act of 1933, that the exemption of All American Burger, Inc., under Regulation A is permanently suspended.

2/ S.E.C. v. Ralston Purina, Inc., 346 U.S. 119 (1953)

3/ In the Matter of Texas-Augello Petroleum Exploration Co., 39 S.E.C. 292 (1959); See,also, S.E.C. v. Sunbeam Gold Mines, Inc., 95 F. 2d 699 (9th Cir. 1938).

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice.

Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party. 4/

Ralph Hunter Tracy
Administrative Law Judge

Washington, D.C.
June 30, 1975

4/ To the extent that the proposed findings and conclusions submitted by the parties, and the arguments made by them, are in accordance with the views herein they are accepted, and to the extent they are inconsistent therewith they are rejected.