

ADMINISTRATIVE PROCEEDING
FILE NO. 3-3319

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
SYDNOR-BARENT SCANNER CORPORATION
File No. 24D-3011

FILED
APR 25 1972

SECURITIES & EXCHANGE COMMISSION

INITIAL DECISION

Washington, D.C.
April 25, 1972

David J. Markun
Hearing Examiner

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :
SYDNOR-BARENT SCANNER CORPORATION : INITIAL DECISION
File No. 24D-3011 :

APPEARANCES: Joseph F. Krys, Assistant Regional Administrator, and William A. Bassett, Jr., John S. Lutz, and Thomas E. Boyle, attorneys, of the Denver Regional Office, for the Division of Corporation Finance.

Richard B. Addis, Esq., and Charles W. Rawson, of Addis and Rawson, Albuquerque, New Mexico, for Sydnor-Barent Scanner Corporation.

Robert L. Lofts, Esq., of Severson, Werson, Berke & Melchior, San Francisco, California, for Messrs. Severson, Werson, Berke, & Melchior, Kurt W. Melchior, and Nicholas S. Freud.

John W. Danfelser, Esq. and Henry A. Kelly, Esq. of Poole, Tinnin, Danfelser & Martin, Albuquerque, New Mexico, for Doherty & Co.

Peter Roosevelt Johnson, Esq., pro se.

T.H. McNary, of Tijeras, New Mexico, pro se.

Kenneth F. Sedler, of Hawthorne, California, pro se.

BEFORE: David J. Markun, Hearing Examiner

CONTENTS

	<u>Page</u>
Appearances.	0
The Proceeding	1
Use of Proceeds and Principal Product.	3
Failure Properly to Disclose Payments to Affiliates15
Failure to Disclose Marketing Efforts.16
Alleged Failure to Cooperate18
Conclusions.22
Public Interest.23
Order.23

THE PROCEEDING

This is a proceeding pursuant to Section 3(b) of the Securities Act of 1933 ("Securities Act") and Rule 261 of Regulation A thereunder to determine whether to vacate or make permanent an order issued by the Commission on November 2, 1971, temporarily suspending the exemption from registration under Regulation A of Sydnor-Barent Scanner Corporation ("SBS", or "Issuer").

On August 26, 1970, SBS filed with the Commission's Denver Regional Office a notification on Form 1-A and an offering circular for the purpose of obtaining an exemption under Regulation A to permit the public offering of 200,000 shares of its capital stock at \$1.50 per share for an aggregate offering price of \$300,000. The exempted securities were distributed to the investing public by the Underwriter, Doherty & Co. under a firm-commitment agreement. The offering circular became effective and all sales to public investors were completed on October 29, 1970.^{1/} The net proceeds of the completed offering, after underwriting discounts but before expenses, amounted to \$270,000 and were received by the Issuer on November 10, 1970. After deduction of expenses incident to the offering the Issuer realized some \$250,000.

In response to the Commission's order of November 2, 1971, temporarily suspending the Regulation A exemption of SBS and advising of an opportunity for hearing, the Issuer and the Underwriter as well

^{1/} The mails were employed in the course of distributing the securities.

as various other interested persons 2/ requested a hearing, which was thereafter held in Albuquerque, New Mexico, from December 13 through December 17, 1971.

The Commission's order reflects charges by the Division of Corporation Finance ("Division") that the offering circular contains untrue statements of material facts and omits to state material facts necessary to make the statements that were made, in the light of the circumstances under which they were made, not misleading, as respects the proposed use of the proceeds of the public offering; the description of the Issuer's proposed business and principal product; the Issuer's sales efforts prior to the public offering; and the intention of controlling shareholders of the Issuer to replace its management within a short time after the public offering. ^{3/} Additionally, the order includes a charge that the Issuer, its officers, directors, underwriter and attorneys failed to cooperate with the staff of the Commission in that they acquiesced in the filing of false and misleading information with the Commission subsequent to a request for information made by the staff. ^{4/}

2/ Requests for a hearing or entry of appearance and requests to be heard were filed by SBS Directors or former Directors Iben Browning, Peter Roosevelt Johnson, James E. Mitchell, Fred W. Warner and Kurt W. Melchior, as well as by the law firm of Severson, Werson, Berk and Melchior and by Kurt W. Melchior and Nicholas S. Freud.

3/ The last of these charges was added towards the close of the hearing by the hearing examiner's grant on December 17, 1971, of the Division's motion to amend the Commission's order of November 2, 1971, to conform to the evidence adduced at the hearing. The Issuer's contention that the hearing examiner lacked authority to amend the Commission's order is not valid. However, this issue is academic in view of the conclusion reached below on the merits of the charge.

4/ See text following footnote 32 below.

The parties have filed proposed findings, conclusions and supporting briefs pursuant to Rule 16 of the Commission's Rules of Practice. ^{5/} The findings and conclusions herein are based upon the record and upon observation of the demeanor of the various witnesses. ^{6/}

USE OF PROCEEDS AND PRINCIPAL PRODUCT

SBS, a New Mexico corporation, was brought into being on March 6, 1970 by its parent corporation, Sydnor-Barent Inc. ("SBI"), a California corporation, in the hope that SBS, with the aid of public financing, would be able to develop, produce and market a certain "flying spot" scanner, a device that transforms pictorial information into a digital format suitable for direct computer processing and which generates pictorial images from previously-processed computer data. Until the public offering involved in this proceeding, SBI owned all of the stock of SBS and after the public offering SBI still owned some 89% of the Issuer. SBS was chosen as the vehicle for production and marketing of the flying-spot scanner because SBI, the parent corporation, was regarded as a high-risk development venture unsuitable for public financing.

As mentioned in its offering circular, the Issuer had acquired from Longshots, Inc., ^{7/} a California corporation, a pre-production model of the scanner it contemplated developing and selling. This

^{5/} 17 CFR 201.16

^{6/} Preponderance of the evidence is the standard of proof applied.

^{7/} Longshots, Inc. is an affiliate of the Issuer by virtue of a controlling interest therein (32%) held by Dr. Iben Browning, president, a director, and a control person of the Issuer.

model came later to be known as the SB 416. The expected retail price was about \$95,000 for the product exemplified by the pre-production model, but the price could go up to two or three times that amount depending upon particular options or features that a buyer might wish to have incorporated into his flying-spot scanner system. One of the special applications of the scanner system, mentioned in the offering circular, lies in the high-density storage of digital information on film which can achieve relatively low-cost archival storage of records for Industry and Government. These systems were expected to retail at up to \$295,000 depending upon particular features. Proposed scanners that could perform these functions came later to be referred to in the SB 1416 series.

The "use of proceeds" statement in the offering circular was as follows:

USE OF PROCEEDS

The net proceeds to be received by the Company from the sale of the shares affected hereby are estimated to be approximately \$250,000. The Company intends that the proceeds will be utilized as follows:

1. Approximately \$70,000 will be added to the general working capital of the Company. Of this sum, \$57,000 will be used for officers' salaries and to reimburse the Company's parent for a share of the Company's officers' salaries, and approximately \$9,000 for employees' salaries; the balance will be used for other operating expenses.

2. Approximately \$110,000 will be used to manufacture additional scanner models and, in that connection, to do limited development work.

3. Approximately \$40,000 will be used in selling, advertising and sales promotional activities.

4. The remaining \$30,000 will be used to purchase additional manufacturing and test equipment.

To the extent that the proceeds of the offering will not be used immediately for the foregoing purposes, they will be temporarily invested in short-term debt obligations or deposited at interest.

The testimony of the officers of the Issuer who prepared the offering circular ^{8/} indicates clearly that in earmarking approximately \$110,000 for the manufacture of "additional scanner models" they had in mind the manufacture of 2 or 3 scanners of the 416 type, or in the event the Company found no market for the 416 but did find a market for variations of the 416, e.g. what later came to be known as the 1416 series, then for as many of such modified scanners as could be manufactured with the funds.

The evidence shows clearly, and the parties are not in dispute on the point, that no 416 or 1416 flying-spot scanner was produced or sold by SBS; nor was any appreciable sum from the proceeds of the public offering or any other source spent in the "development" of either the 416 or the 1416.

SBS had attempted to market the SB 416 from the time of its incorporation in March, 1970. While a number of the firms contacted had expressed interest in a general way, things never got to the order stage with any potential client.

After the funds from the public offering had become available

^{8/} The offering circular was prepared by Melchior's law firm under his supervision and SBS's officers and directors T.H. McNary (executive vice president) and Kenneth F. Sedler (treasurer) also participated importantly in its preparation. Draft offering circulars and questionnaires were circulated to all SBS board members and each of the board members acknowledged receipt of the Notification and Offering Circular and approved its contents. The use-of-proceeds section of the offering circular was prepared in the course of a three-day meeting in Albuquerque, New Mexico among Messrs Melchior (secretary and counsel), McNary, Sedler, Johnson (president), and Henry Schutzberger (vice president and general manager), during which consideration was given to an initial allocation of proceeds and substantiating data prepared by Sedler, treasurer and chief financial officer of SBS, who in turn had consulted with various officers and operating personnel to arrive at cost estimates for building the scanner and other costs.

to SBS, McNary, the Issuer's Executive Vice President, attended a "Conference and Exhibit" in Houston, Texas, sponsored by the American Federation of Information Processing Societies, at which he was able to assess the SB 416's competition better than anyone at SBS had to date been able to do. McNary's conclusion, based on the number and experience and qualifications of the competing firms, as well as on the products they had developed and shown, was that SBS would have to be rather lucky to find a market for its SB 416. These views were reflected in two intra-company documents: (a) a "Near-Term Program Plan" dated December 1, 1970, authored by McNary and Henry Schutzberger, Vice President and General Manager, and (b) a "Long-Range Program Plan" dated December 18, 1970, prepared by McNary, in which Schutzberger concurred.

Confronted with these bleak prospects for marketing the SB 416, SBS had to determine how it could employ the proceeds of the public offering consistently with the representations made in the offering circular.

McNary's Long-Range Plan proposed, subject to the existence of full funding in SBI, ^{9/} that SBS attempt to develop and market, for a "reasonable period" of about 1 year, the SB 1416 TFT Recorder,

^{9/} It had been contemplated that SBI would obtain operating funds from additional contributions of capital by private investors. The most likely prospect was a cousin of Johnson's named Fisk. For reasons that are not entirely clear from this record, such additional capital was not obtained by SBI. It may be that the SBS dispute as to management, discussed below, or SBS's inability to market the 416 scanner, or general economic conditions at the time, caused SBI's inability to get added capital from Fisk or others. This had an indirect effect on SBS inasmuch as the two companies had an agreement under which they shared the salary expense

a system for archival storage which would be embraced within the representations as to use of proceeds made by the offering circular, and a television monitor, which would qualify within the contemplation of "other business" referred to in the offering circular. His proposal contemplated that if after a year's time this plan of action had not achieved satisfactory results the company would be liquidated with the return of remaining funds to creditors and stockholders.

The McNary proposal was not adopted. Instead, Dr. Iben Browning ("Browning"), a member of the Issuer's board of directors and a 32% owner of SBI, ^{10/} utilized the predicament that SBS and SBI found themselves in during November and December of 1970 to oust McNary and various other members of the then-existing SBS management team by, in effect, forcing their resignations by having SBS adopt policies that were both outside the contemplation of the offering circular and offensive to the resigning officers' concepts of orderly business management and planning.

Beginning about mid-November of 1970 Browning began voicing dissatisfaction ^{11/} with the SBS management team, specifically, with

9/ (continued)

of various officers and personnel who served both entities. Thus, if SBI were unable to pay its share of such expenses, SBS would have to make up that portion if it was to retain the personnel.

10/ Johnson held an even larger ownership in SBI, the Issuer's "parent", and the two together held the bulk of the SBI stock.

11/ Though Brownings' background and experience were primarily that of an inventor and a scientist, he had had some business experience and did not hesitate to express his views or to act in business affairs.

McNary ^{12/} and Sedler. Browning regarded McNary as well qualified for management of highly-structured, big-budget projects such as those involved in large aerospace projects that he had managed, but regarded him as incompetent for the management of small companies such as SBS where the managerial talents called for were, in Browning's view, the ability to "get on with it" and to seize business opportunities wherever and whenever they might pop up.

At a meeting held in San Francisco on December 5, 1970, at the offices of Melchior, secretary, a director, and legal counsel to SBS, which was convened to consider Browning's criticisms of management as well as the other problems then facing SBS, ^{13/} Browning demanded that control of SBS be handed over to him immediately, and claimed to be supported in this position by James Mitchell, a director, and by Edward Doherty, principal of the Underwriter. Browning stated it was too late for "rational plans" of the kind proposed by McNary and Browning proposed, without getting specific, to pursue "targets of

^{12/} McNary had never been Browning's choice. Browning had favored Schutzberger for the post to which McNary was named. Additionally, McNary's enthusiasm for the development of Browning's inventions, which he presented from time to time, was not as unbounded as Browning might have wished. In Browning's estimation McNary was overly concerned with how the particular proposal would fit into planned corporate objectives.

^{13/} Those in attendance were Browning, Peter Johnson (president, and a director of SBS and largest shareholder of SBI), Fred Warner (a director), McNary, Sedler, Nelson Winkless III (a director who sided with Browning), and Melchior.

opportunity" by "explosive action". Browning's business philosophy came to be referred to as the "nuclear plan", which envisioned SBS as the core or center of the nucleus, ready to reach out and seize upon any business opportunity that might come into view. In contradistinction McNary's plan was the so-called "flag plan", used commonly by industry, which involves the pursuit of defined, pre-established objectives and programs with allocated budgets and established time spans.^{14/} Melchior, McNary, and Sedler considered that Browning's nuclear plan was in effect no plan at all since it presupposed freedom to move in any direction at any time, and considered that it could not be reconciled with the representations made in the offering circular. Melchior had previously advised SBS and its officers and directors in writing, on November 30, 1970, of his view that departure from the business plan set forth in the offering circular so soon after the offering date of October 29, 1970, would pose a very serious question as to the good faith of the representations made in the offering circular.

Thereafter further discussions and meetings were held in Albuquerque, New Mexico. At a meeting there on December 9, 1970, Johnson, who together with Browning owned more than a majority interest in SBI, which in turn owned some 89% of the shares of SBS, stated that he would support Browning's demand for management control

^{14/} Representation graphically of a company's various programs takes on the appearance of the stripes in the U.S. flag, hence the characterization "flag plan".

and that he would utilize his voting power in SBI to replace, if necessary, directors of SBS who might oppose Browning. Subsequently, this reality was formally recognized at a meeting of the Board of Directors of SBS in San Francisco, California, on December 29, 1970, when McNary, Melchior, Sedler, and Warner bowed to the voting power of Browning and Johnson and resigned their offices and directorships.^{15/} The record indicates that Johnson supported Browning notwithstanding some reservations as to his talent for management^{16/} because he considered Browning "indispensable" to the future well being of SBI and SBS, particularly as respects Browning's ability to attract additional capital to the firms.^{17/}

While conceding that no SB 416s or SB 1416s were constructed or developed out of the proceeds of the public offering, SBS contends that its use of such funds for the manufacture of a device called a "character generator" was consistent with the offering circular, arguing that the character generator is a form of digitizing or flying-spot scanner.

The character generator is described by the Issuer as an alpha-numeric television presentation system. It is about 18"

^{15/} At this same meeting the resignation of Schutzberger, and Albert T. Ussery, Assistant Secretary and Albuquerque counsel to the firm, submitted by McNary, were also accepted; Jules F. Appelman, who had marketing responsibilities with SBS, resigned as vice president and director of SBI at about the same time.

^{16/} Johnson stated at the time that Browning was only temporary and would be replaced eventually by seasoned business management but as of the time of the hearing such change had not been made.

^{17/} The record suggests that Doherty placed considerable reliance upon Browning's experience and background as a scientist and inventor in terms of being able to interest prospective investors in SBS or SBI. (Doherty himself was not called upon to testify by any party.)

square and 5" high. It is used, primarily, by cable television companies.

On December 14, 1970, Browning negotiated an agreement ^{18/} between SBS and Marketing Systems, Inc. ("MSI"), which Johnson signed as president of SBS, under which SBS agreed, among other things, to utilize its job-shop manufacturing facilities to construct for MSI one hundred "character generators" at a price of \$1,390 each, which MSI intended to market. Under this contract SBS manufactured and shipped some 30 of the character generators by the time of the hearing, but the record is not clear as to how much money was spent in their manufacture.

Although Browning's testimony at the hearing to the effect that the character generator falls broadly within the description of flying-spot scanner technology stands uncontradicted in the record, it is abundantly clear that character generators were not the scanners described and contemplated by the offering circular. ^{19/} The scanner contemplated by the offering circular was to sell from \$95,000 on up, depending upon optional features — the character generator sold for \$1,390 each. The functions which the character generator can perform are much more limited than those of the contemplated scanner, e.g. the character generator can only "write", whereas the contemplated

18/ He also signed the agreement as a third party thereto as "inventor".

19/ Witnesses who had participated heavily in drafting the offering circular testified that the flying-spot scanner contemplated was the 416 or variations thereof. Browning testified that the term "flying-spot scanner" covered as broad a range of products as "electric motors". Assuming this to be true, and carrying the comparison a step further, it could hardly be argued successfully that an offering circular that spoke of the manufacture of a particular kind of electric motor would contemplate and authorize manufacture of any and all types of electric motors.

scanner can both "read" and "write". 20/

Moreover, the offering circular discussed and contemplated a scanner to which SBS had the production and selling rights, i.e. the model and related rights acquired from Longshots, Inc., whereas the contract with MSI gave SBS no selling rights and was, in reality, merely a means of putting the SBS job-shop facilities to work to get some revenue for SBS at a time when the company was having no luck selling the 416 or 1416 scanners. The contract was not entered into until well after the public offering and, so far as this record shows, was not in anyone's contemplation until about the time the contract was executed. The immediate motivation for the MSI contract was evidently to show that Browning could generate business for SBS. 21/

In view of the heedless manner in which Browning and Johnson, who through their control of SBI in turn controlled SBS, departed from a product-emphasis plan that would have been consistent with the offering circular and embarked upon the character generator contract and other activities which were not consistent with the use-of-proceeds representations in the offering circular, 22/ in the face of the

20/ Browning testified that with appropriate adaptations the character generator could be made to serve as a component part of a flying-spot scanner of the SB 416 or 1416 type.

21/ The Issuer itself, in a proposed offering circular filed with the Commission's Denver Regional Office on May 20, 1971, in which its proposed flying-spot scanner is discussed extensively on pp. 8-10, discusses the "character generator" briefly, and separately, at p. 12, with no suggestion that the character generator is a species of flying-spot scanner. SEC File 24-D-3093-1.

22/ As of July 23, 1971, the Issuer had only approximately \$13,000 in cash, the source of which could have been proceeds from the public offering.

repeated warnings by Melchior, McNary and others as to the inferences that might be drawn from such actions, it is concluded that the Issuer's representations as to use of proceeds were untrue at the time the offering circular became effective in that Browning and Johnson must have contemplated at the time that if purchase orders for the 416 or variations thereof were not obtained the funds would be utilized for whatever business activity seemed most promising at such later time. ^{23/}

The Division also charges ^{24/} and urges that the fact of the occurrence of the management change in SBS so soon after the offering circular became effective calls for an inference that the representations as to the composition of SBS management contained in the offering circular were false in that SBS then knew it would shortly make an abrupt and major change in management.

The record is quite clear that McNary, Sedler, and Melchior had no inkling of the impending management change that was to result in their ouster by "resignation" until about mid-November, 1970. There is insufficient evidence in this record to permit an inference that

^{23/} Parenthetically it should be noted that the Issuer, contending as it does that its use of the proceeds of the public offering did conform with the representations of the offering circular, does not contend that the lack of adequate funding in SBI (see footnote 9 above) was an unforeseeable event that justified departure by SBS from its representations as to use of proceeds. The record would not support such an argument, had it been made, because, among other things, the salary contribution by SBI was not of a magnitude sufficient to require such departure by SBS. The salary contribution of SBI would have been about \$40,000 per annum. The primary problem faced by SBS was not the lack of sufficient capital in SBI but the Issuer's apparent lack of prospect for selling its SB 416 or SB 1416 scanners coupled with Browning's desire to take over management.

^{24/} See footnote 3 above.

Doherty or Doherty & Co. knew at the time of the offering of any impending management change. While Browning at the December 5, 1970, meeting stated he was carrying out the wishes of Doherty, the latter later denied any such intentions to Melchior and others ^{25/} and stated that he was primarily interested to see that public investors in SBS would not have their funds improperly diverted to SBI and that their interests were otherwise protected. Moreover, there is no adequate proof as to how much earlier than December 5 Doherty became aware of any management problems at SBS.

Whether Browning and Johnson, ^{26/} who together controlled SBS through their controlling ownership of SBI, intended at the time of the effective date of the offering circular to replace existing management of SBS shortly thereafter cannot be fairly determined from this record. There is no direct evidence that they did and the evidence from which an inference that they did might be drawn is insufficient, particularly as to Johnson given the evidence that the management change was triggered by SBS's inability to sell, and lack of prospect for selling, the SB 416 flying-spot scanner and in lesser part by the inability of SBI to obtain adequate funding. ^{27/}

25/ Doherty, though represented at the hearing by counsel and present personally much of the time, did not choose to testify, and no other party called him as a witness.

26/ Johnson (an attorney), who appeared at the hearing pro se, chose not to testify, and no party called him to testify.

27/ See footnotes 9 and 23 above.

FAILURE PROPERLY TO DISCLOSE PAYMENTS TO AFFILIATES

The Commission's order of November 2, 1971, includes a charge by the Division that the Issuer failed to disclose that a substantial amount of the proceeds of the offering was to be allocated to affiliated companies and persons.

The record establishes that during the period November 10, 1970 to July 23, 1971 the Issuer paid over \$40,000 to three affiliates^{28/} out of the proceeds of the public offering. The Issuer concedes the payments were made to its affiliates but urges that as to two of the affiliates intention to make the payments was fully disclosed and that as to the third, the Thomas Bede Foundation, payments to it were not foreseen and became necessary only when the management change occurred and SBS turned to the Thomas Bede Foundation, Browning's creation,^{29/} for management services.

The Issuer urges that disclosure on page 8 of the offering circular under the heading "Existing Contractual Arrangements" of its obligation to pay royalties to Longshots, Inc. and to retain as a consultant

^{28/} Longshots, Inc. received \$18,750; Nelson B. Winkless, Jr. was paid \$10,666.48; and the Thomas Bede Foundation received \$12,113.61.

^{29/} The Thomas Bede Foundation was organized initially as a non-profit tax-paying foundation by Browning and his wife in California and later "transferred" to New Mexico. Essentially it served as a vehicle for Browning to perform his consulting services and contract Research & Development work for Sandia and other corporations through a corporate entity rather than as an individual.

