

January 1969

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Recommended Citation

J. Lani Bader, *Business Associations*, 1969 Cal Law (1969), <http://digitalcommons.law.ggu.edu/callaw/vol1969/iss1/8>

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Business Associations

by *J. Lani Bader**

The new Corporate Securities Act,¹ which became effective January 2, 1969, represents a sweeping change in the total fabric of administrative securities regulation. Indeed, no legislative act during the last decade has been of more importance to the lawyer representing business interests.

Also of considerable importance is the 1968 adoption of the Professional Corporation Act, which marks the entry of the corporation in California into a hitherto closed area. Since this enactment is referred to in another article in this volume,^{1,1} the comments here will be restricted to a discussion of the new Corporate Securities Act and of the changes it has wrought in the law of business associations. It should

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The author extends his appreciation to Wally G. Hesseltine, student at

Golden Gate College, School of Law, for assistance in preparation of this article.

1. Cal. Corp. Code §§ 25000-25804.

1.1. See Reigger, *LEGAL PROFESSION*, in this volume.

be noted that the statute is totally comprehensive and, with the new rules, displaces all the existing legislation over the total spectrum of securities regulation, but that this article covers *only* that topic of widest interest—control and regulation of securities distributions.

Before proceeding with the discussion, at least passing attention should be paid to three of the approximately two dozen cases decided in the period under review. Two of these, *People v. Western Air Lines*² and *Western Air Lines v. Schutzbank*,³ represent the last gasps of the well-known battle between Western Air Lines and the Department of Investment over the amendment of Western's articles of incorporation to eliminate cumulative voting. This conflict, which began in 1961 with *Western Air Lines v. Sobieski*,⁴ has been productive of too much comment to bear further discussion.⁵ The third case, *Hecht v. Harris, Upham & Co.*,⁶ is of interest only because of the view it affords of the trading practices of one of our large brokerage houses.

The Corporate Securities Act—Out with the Old—In with the New

The old securities act⁷ has been regarded by practitioners as one of the most inclusive regulatory schemes of its kind.⁸ Starting with a definition of "security" broad enough to encompass such diverse interests as chinchilla⁹ on the one hand and country club memberships¹⁰ on the other, the act proceeded to declare that any security issued without a current definitive

2. 258 Cal. App.2d 213, 66 Cal. Rptr. 316 (1968).

3. 258 Cal. App.2d 218, 66 Cal. Rptr. 293 (1968). For further discussion of this case, see Manuel, ADMINISTRATIVE LAW, in this volume.

4. 191 Cal. App.2d 399, 12 Cal. Rptr. 719 (1961).

5. See 49 Cal. L. Rev. 974; 14 Hastings L. Journ. 96; 55 Cal. L. Rev. 33.

6. 283 F.Supp. 417 (D.C. Cal. 1968).

7. Former Cal. Corp. Code §§ 25000-26104.

8. Perhaps the best overview of the old act is found in Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act* (Parts I, II, and III found in 33 and 34 Cal. L. Rev.).

9. *Hollywood State Bank v. Wilde*, 70 Cal. App.2d 103, 160 P.2d 846 (1945).

10. *Silver Hills Country Club v. Sobieski*, 55 Cal.2d 811, 13 Cal. Rptr. 186, 361 P.2d 906, 87 A.L.R.2d 1135 (1961).

Bader: Business Associations

permit was “void.”¹¹ Although the act made specific securities exempt from its application,¹² there were no transactional exemptions at all. Thus the act, on its face, applied with equal force to the person who desired to form a family corporation with his spouse as the only other shareholder and to the promoter who desired to effect a wide distribution of securities to the public. Further, the act contained the specific requirement that the Commissioner of Corporations determine that the “proposed plan of business of the applicant and the proposed issuance of securities are fair, just and equitable”¹³ without regard to the fact that in many circumstances a literal application of that standard would require the commissioner to protect one as a prospective shareholder against himself as an issuer. Adding to the problem was the fact that the statute included within its definition of sale “. . . any change in the rights, preferences, privileges, or restrictions on outstanding securities.”¹⁴ Since that section was interpreted to cover *any* proposed change, whether beneficial to the shareholders or not, almost any proposed alteration of the corporate status quo required that a permit be obtained.¹⁵

This somewhat confused state of affairs was complicated by the proscription that the security issued without a permit being in effect was “void”. Consider the person who had purchased twenty shares of an issuer which, though poorly promoted and inadequately put together, had experienced a ten-fold increase in the price of its securities, all of which had been sold without a permit being in effect. The protection

11. Former Cal. Corp. Code § 26100.

12. Former Cal. Corp. Code §§ 25100, 25102.

13. Former Cal. Corp. Code § 25507. The specific language of this section was as follows: “If the commissioner finds that the proposed plan of business of the applicant and the proposed issuance of securities are fair, just, and equitable, that the applicant intends to transact its business fairly and honestly, and that the securities that it proposes to issue

and the method to be used by it in issuing or disposing of them are not such as, in his opinion, will work a fraud upon the purchaser thereof, the commissioner shall issue to the applicant a permit Otherwise, he shall deny the application. . . .”

14. Former Cal. Corp. Code § 25009 (a).

15. Dallas, Edgar, *Handbook of Basic Practice Before the California Division of Corporations*, 1963.

afforded him by a literal interpretation of the act would result in a totally worthless security.

The inadequacy of such a statutory formula is also demonstrated by considering the dilemma of the issuer who in years past issued a security the day before the date of the relevant permit. Technically, even though the very existence of the permit would have indicated that the issue of the security was fair, just and equitable, the security was void—and the act provided no way to cure such a trivial deficiency.¹⁶

Of course, some of the defects mentioned above fell under court scrutiny and did not survive the encounter. The minute it became apparent that a literal interpretation of the act could be used as a sword and not a shield, the courts did what courts have always done—disregarded the language and gave effect to what must have been the legislative intent. Thus, the courts have held that “void” means “void at the option of the aggrieved shareholder”¹⁷—that is, unless the shareholder is in *pari delicto*, in which case it means what it says.¹⁸

Further, the standard of “fair, just and equitable” was subject to varied interpretations. If the issuer was a family corporation with one prospective shareholder, the standard was met regardless of the proposed terms of issue, as long as the shares were deposited in escrow¹⁹ to prevent their transfer to

16. One of the most desirable side effects of the new act will be the curing of this form of technical deficiency which existed under the old act. Sections 25800 through 25804 of the new act provide a method for obtaining curative permits to validate securities which are technically void under the old act because of a failure to obtain a permit before the issuance of the security. These sections will be in effect through January 2, 1972, and will allow the obtaining of a permit with retrospective application to old transactions.

17. See *Robbins v. Pacific Eastern Corporation*, 8 Cal.2d 241 at 277, 65 P.2d 42 at 61 (1937): “In spite of the

general language found in some of the cases that stock issued in violation of the Corporate Securities Act is ‘void’, it is well-settled that that act belongs to that type of statute which is aimed at one class for the protection of another class. In other words, the prohibitions and penalties of the Corporate Securities Act are leveled against the seller and not against the buyer. This is well settled”

18. *Domestic & Foreign Pet. Co. v. Long*, 4 Cal.2d 547, 51 P.2d 73 (1935).

19. The escrow device was created by § 25508 of the Cal. Corp. Code. The commissioner’s authority for the escrow condition is continued under the new

members of the public who needed the protection of the act.

Another defect in the act was its failure to expressly regulate nonissuer transactions. Here the problem concerned two kinds of sales: first, the sale by a bona fide owner (but not issuer) of a security for his own account in anything other than an isolated transaction and second, the sale by a bona fide owner (but not issuer) for the indirect benefit of the issuer, i.e., the typical firm underwriting. Although the act exempted the first type of transaction, it appeared to have closed the second through section 25152, which exempted a sale of securities:

(a) made by or on behalf of a vendor not the issuer or underwriter thereof who, being a bona fide owner of the securities disposes of his own property for his own account, and (b) the sale is not made, directly or indirectly, for the benefit of the issuer or an underwriter of the security, or for the direct or indirect promotion of any scheme or enterprise with the intent of violating or evading any provision of the Corporate Securities Law.

Although that language seems to indicate beyond doubt that the act intended to regulate underwritten offerings, an unpublished Attorney General's opinion concluded that the act did not apply to underwritten distributions when the delivery of the securities was made outside of California, even though the securities were immediately resold in this state.²⁰ Apparently that opinion was predicated on those cases holding that the act did not cover distributions of foreign issuers consummated outside of California even though the negotia-

act, as is the alternative position that a legend restricting transfer without the commissioner's consent be endorsed on the face of the certificate, thus preventing further distributions not subject to his control. Cal. Corp. Code § 25141, and rules 260.141.10 et seq. Further, the proposed regulations anticipate that the legend condition rather

than the escrow will be the preferred form of restriction, for rule 260.141.13 permits the escrow holder, at his option, to substitute the legend restriction for the escrow condition in respect of existing permits.

²⁰ 27 Op. Cal. Att'y Gen. No. 2780 (1940).

tions with respect to the sale of the securities took place in this state.¹

Although the commissioner retained some measure of control over such distributions through the requirement that any advertisement (including a prospectus) used in connection with any sale of securities be filed in his office not less than one day prior to its intended use and that it not be disapproved by him,² the failure to directly regulate such distributions was a major failing of the act.

The new legislation totally abandons the conceptual scheme of the old. Regulation is extended to all transactions involving the sale of a security, whether issuer or non-issuer. Qualification by permit is limited to those issuer distributions which are not registered under the Securities Act of 1933³ and which do not involve securities of a registered investment company or of a company which has a security registered under section 12 of the Securities Exchange Act of 1934.⁴ For registered offerings, the qualification is by coordination; for non-registered offerings involving the security of a company which has a security registered under section 12 of the Securities Exchange Act of 1934 or under the Investment Company Act of 1940,⁵ qualification is by notification.

Further, the new act imposes only civil and criminal liabilities for violations; the old sanction that a security not issued in compliance with the act is void is completely gone. In addition the act provides a method by which the commissioner may prevent a distribution on the ground that it is not fair, just and equitable; the making of such a finding is permissive rather than mandatory.

1. See *Robbins v. Pacific Eastern Corporation*, 8 Cal.2d 241, 65 P.2d 42 (1937), and the excellent discussion contained in Dahlquist, *Regulation and Civil Liability Under the Cal. Corp. Sec. Act*, at 387.

2. Former Cal. Corp. Code § 25602.

3. 15 U.S.C.A. §§ 77a-77aa.

4. 15 U.S.C.A. §§ 78a-78jj. That

act requires every issuer who has total assets in excess of \$1,000,000 and an equity security held of record by 500 or more persons to register the security under section 12, unless otherwise exempt under that section.

5. 15 U.S.C.A. §§ 80a-1 through 80a-52.

The remainder of this article will be devoted to an examination of specific areas governed by the new act.

Issuer Transactions

The basic section with respect to issuer transactions is section 25110, which makes unlawful an offer of sale of any security in California by any issuer unless qualified. Three forms of qualifications are provided: coordination, notification, and permit.

Who Is An Issuer

Section 25010 contains the basic definition of issuer. Under this section an issuer is “. . . any person who issues or proposes to issue any security . . . whether or not by or through underwriters” Underwriter in turn is defined in section 25022 as follows:

. . . a person who has agreed with an issuer or other person on whose behalf a distribution is to be made (a) to purchase securities for distribution or (b) to distribute securities for on on behalf of such issuer or other person or (c) to manage or supervise a distribution of securities for or on behalf of such issuer or other person.⁶

Unlike issuer transactions, nonissuer transactions are controlled through defining the form of the *transaction*, rather than attempting to define *who* is a nonissuer: “It is unlawful for any person to sell any security in this state in any nonissuer

6. The act's definition of underwriter is interesting to compare with the analogous definition under the Securities Act of 1933, 15 U.S.C.A. § 77b(11): “. . . ‘underwriter’ means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such under-

taking; As used in this paragraph the term ‘issuer’ shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.” The federal definition is much broader in scope than the California definition and covers, among others, distributions by the underwriter without an agreement with respect to the distribution between the underwriter and the issuer.

Business Associations

Cal Law Trends and Developments, Vol. 1969, Iss. 1 [1969], Art. 8

transaction . . .”⁷ Nonissuer transaction in turn is defined as “. . . any transaction not directly or indirectly for the benefit of the issuer.”⁸ That inconsistency in definition is unfortunate, for when coupled with the definition of “underwriter”, one who has *agreed* to make a distribution on behalf of an issuer, it results in a strange gap in the scope of the act’s coverage of non-exempt distributions.

The problem arises when one assumes that the purpose of the act is to cover all distributions, whether nonissuer or issuer, by assigning responsibility to the person primarily responsible for the transaction. For that reason one must assume that a transaction which is excluded from the definition of nonissuer transaction because it is for the direct or indirect benefit of the issuer was meant to be necessarily proscribed as an issuer transaction. Since the act, however, controls issuers, rather than issuer transactions, a distribution by a person for the indirect benefit of the issuer without the issuer’s knowledge falls into a curious limbo between the two.

Consider the case of the person who has owned for years a large block of shares in a corporation which his son controls or owns the remaining stock; consider further that the corporation has fallen into bad times and cannot survive without a large injection of new capital. Assume that the father, without the knowledge of the son, altruistically decides to make a public distribution of his shares and turn the proceeds over to the corporation. Is this an issuer or a nonissuer transaction? It is clearly not proscribed by section 25110 for that section only prevents sales by issuers, which the father is clearly not. Further, he is not an underwriter for there is no overt agreement between him and the corporation. Is it then a nonissuer transaction? Apparently not, for the transaction clearly appears to be for the indirect benefit of the corporation which section 25011 exempts from the scope of nonissuer transaction. Magically, the distribution appears not to be covered at all. The problem, of course, arises from the approach of the act. Rather than simply prohibiting *all* distributions, and then assigning liability based upon who

7. Cal. Corp. Code § 25130.

8. Cal. Corp. Code § 25011.

was primarily responsible for the illegal distribution, the act attempts to separate distributions into two disparate categories, one based upon the nature of the distribution and the other upon who does the selling.

The suggestion for curing the problem is simple. Rather than prohibiting any person from selling in a nonissuer *transaction*, prohibit any person not an issuer from selling in *any* transaction, excluding underwriters. The two proscriptions would then include *all* transactions.

Exemptions Available to Issuers

Four separate categories are available to issuers. The first category relates to the nature of the security and is applicable to issuer and nonissuer alike. The other categories relate to transactional exemptions and depend upon the form of the distribution rather than the security being distributed.

Exempt Securities. Those securities made exempt under the new act largely parallel the exemptions under the old law. They primarily consist of securities issued by states and political subdivisions or by issuers subject to regulation by other agencies. Two exemptions, however, mark major departures from the old law.

First, subsection 25100(j) exempts:

any security . . . of an issuer organized exclusively for educational, benevolent, fraternal, religious, charitable, social or reformatory purposes and not for pecuniary profit, if no part of the net earnings of the issuer inures to the benefit of any private shareholder or individual.

The above provision dispatches the doctrine of *Silver Hills Country Club v. Sobieski*,⁹ which held that country club memberships were securities within the meaning of the old act, even though the members gained only the right to use club facilities and were not entitled to share in assets or earnings. The court reached its conclusion on the basis that because

⁹ 55 Cal.2d 811, 13 Cal. Rptr. 186, 361 P.2d 906, 87 A.L.R.2d 1135 (1961).

the right to use the club facilities was irrevocable the membership represented a beneficial interest in property, one of the tests of a security.

That an exemption is now provided for this type of distribution appears warranted because the holding under the old act that a country club membership is a security represents an anomaly. The one problem which might exist under the new exemption—that of the promoter who forms the club and makes an indirect profit through the sale of land or services to it rather than directly through salaries or dividends—is disposed of by not making the exemption available where “. . . any promoter . . . expects or intends to make a profit directly or indirectly from any business or activity associated with the organization or operation of such nonprofit organization or from remuneration received from such nonprofit organization.”¹⁰

Second, subsection 25100(a) marks an astonishing departure from the existing law and exempts, “[A]ny security listed or approved for listing upon notice of issuance on the New York Stock Exchange; and any warrant or right to purchase or subscribe to any such property.”

The decision of the legislature to exempt the New York Stock Exchange listed securities can only be justified upon the assumption that the Department of Stock List is in a position to better protect the rights of the California investor than a California regulatory body.

Although most practitioners who have had extensive experience with administration of the old act would agree to some extent with that assumption, the underlying problem is more related to the competence of the administrators than to the act itself. The fair, just and equitable standard is, like motherhood, difficult to quarrel with. The breakdown came with the application of the standard. The permit issued in 1959 to Cal-West Aviation, Inc., is instructive. There, the commissioner authorized Cal-West, a newly formed California corporation, to issue two classes of stock, class A and

¹⁰ Cal. Corp. Code § 25100(j).

Bader: Business Associations

class B, both common. Class A was non-voting, par value \$5.00 per share, and the issuer was authorized to sell 240,000 shares (an aggregate of \$1,200,000) to the public. The class B was voting, had a par value of five cents per share, and the issuer was authorized to sell 62,453 shares (a sum of \$3,122.65) to the promoters.

On the other hand, any practitioner who consistently deals with the commissioner's office can relate many instances of a too-zealous application of the standard in what appear to be completely legitimate issues. The difficulty, of course, arises with the fact that in many instances the act has been applied by administrators without the necessary background or training to fully comprehend just what it is they are supposed to do. Thus, in instances like these, there can be no quarrel with California's decision to abdicate its regulatory power where another body, with sufficient experience and background, is already applying a standard designed to protect the public against abuse.¹¹ At any rate, the exemption, to the extent that it applies to listed securities, represents an interesting—and novel—experiment.

However, the second portion of the subsection 25100(a) exemption which, as noted above, exempts “. . . any warrant or right to purchase or subscribe to [any New York Stock Exchange listed security]” represents a questionable departure from existing practice for it exempts a security which is totally nonregulated. The mere fact that the warrant is ultimately convertible into a listed security provides no control at all over the terms of the warrant if the warrant *itself* is not listed. Hence, such matters as terms of conversion, sale price, and manner of sale are completely left to the whim of the issuer.

11. The New York Stock Exchange Company Manual gives the following as the basic consideration for listing: “The company must be a going concern or be the successor to a going concern. While the amount of assets and earnings and the aggregate market value are considerations, greater emphasis is

placed on such questions as the degree of national interest in the company, the character of the market for its products, its relative stability and position in its industry, and whether or not it is engaged in an expanding industry with prospects for maintaining its position.”

Exempt Transactions. Those transactions made exempt under the new act are in most instances complete departures from the old law. They are found in three separate sections of the act.

Section 25102 covers those exemptions available only to issuers in connection with conventional security distributions; section 25103 relates to those exemptions available to issuers where the distribution is concerned with a merger, or a change in shareholder rights with respect to existing securities; section 25104 relates to nonissuer transactions. Because of the different nature of the transactions envisaged by each of the sections, we will treat section 25102 and section 25103 separately, and cover section 25104 under nonissuer transactions.

Section 25102 Exemptions. Here we find the act making a distinction between offer and sale. Three of the exemptions are available for offers only, with the balance available both for offers *and* sales.

Two of the three offer exemptions are totally new. The first, subsection 25102(a),¹² covers the situation where there is no public offering and the agreement with respect to the offer contains a statement much like the red herring caption used on preliminary prospectuses under the Securities Act of 1933; the second, subsection 25102(b),¹³ covers offers made through preliminary prospectuses where a registration state-

12. Cal. Corp. Code § 25102(a): "Any offer (but not a sale) not involving any public offering and the execution and delivery of any agreement for the sale of securities pursuant to such offer if (1) the agreement contains substantially the following provision: 'The sale of the securities which are the subject of this agreement has not been qualified with the Commissioner of Corporations of the State of California and the issuance of such securities or the payment or receipt of any part of the consideration thereof prior to such qualification is unlawful. The rights of all parties to this agreement are expressly conditioned upon such qualifica-

tion being obtained.;" and (2) no part of the purchase price is paid or received and none of the securities are issued until the sale of such securities is qualified under this law."

13. Cal. Corp. Code § 25102(b): "Any offer (but not a sale) of a security for which a registration statement has been filed under the Securities Act of 1933 but has not yet become effective, if no stop order or refusal order is in effect and no public proceeding or examination looking toward such an order is pending under Section 8 of such Act and no order under Section 25140 or subdivision (a) of Section 25143 is in effect under this law."

Bader: Business Associations

ment has been filed under the Securities Act of 1933. The third, subsection 25102(c), is simply a continuation of prior law, exempting offers where the offeror has secured a negotiating permit.

Subsection 25102(a) is a welcome change from prior law. Although the old act required a negotiating permit in this situation, this requirement was probably more honored in its breach.¹⁴ Subsection 25102(b) is only applicable in registered offerings, and is to facilitate qualification of the sale through coordination. (Coordination will be discussed later.)

The balance of the exemptions, applicable to both offers and sales, in part continue existing law and in part represent a withdrawal of regulation from transactions where there is nobody to protect or where the need for protection is limited.

In the former category fall subsections (e), (f), (g), and (k) of section 25102 covering, respectively, the non-public offer and sale of evidences of indebtedness, partnership interests, conditional sales contracts, and reorganization plans subject to the jurisdiction of a bankruptcy court. Unfortunately, the new act does not attempt to define what is and what is not a public offering, within the meaning of these sections.

The commissioner attempted to cure this deficiency through his rule-making authority. The proposals came in the form of two new regulations,¹⁵ the first of which, section 260.102.1, applies to transactions under section 25102(a) of the act, and the second, section 260.102.2, applies to transactions under sections 25102(a), (e), (f), and (g) of the act. The first of these regulations applies a rule of thumb that more than 25 offerees makes an offering public. The second incorporates what appears to be a hodgepodge of three dissimilar ideas: (1) the concept of public offering developed by the California courts under the old act, relating primarily to pre-existing business relationships between the offeror and the

¹⁴. This was partially because the cases had held that the lack of the negotiating permit did not vitiate the ultimate sale of the security as long as there was a definitive permit in effect

at the time that the sale was consummated.

¹⁵. Title 10, Cal. Adm. Code §§ 260.102.1, 260.102.2.

offeree;¹⁶ (2) the test established by the courts under the Securities Act of 1933, which relates to the financial sophistication of the offeree and his access to information concerning the offeror;¹⁷ and (3) the “20 to 25 offerees” rule of thumb developed by practitioners and tolerated by the commission.¹⁸

The text of section 260.102.2 of the Rules is as follows:

For the purposes of Subdivisions (e), (f), and (g) of Section 25102 and Subdivision (a) of Section 25104 of the Code, an offer or sale does not involve any public offering if offers are not made to more than 25 persons and sales are not consummated to more than 10 of such persons, and if all of the offerees either have a preexisting personal or business relationship with the offeror or its partners, officers, directors or controlling persons or by reason of their business or financial experience could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction. The number of offerees referred to above is exclusive of any described in subdivision (i) of Section 25102 of the Code. . . .

The test is most unfortunate and appears to stem either from a lack of conviction or from the lack of ability to clearly think through the problem of the public-offering exemption. If certainty alone is the goal, then a flat exemption of an offering in which a certain minimum number of offerees is involved should be provided. If sophistication of the offeree is viewed as eliminating the necessity for regulation, then the test should be phrased in those terms. The unfortunate conjunction of the two, however, leads inescapably to the conclusion that the test has something to do with a minimum number of sophisticated offerees. There was probably no intent to create such a test, and such a test is certainly not desirable.

The exemption provided for by section 25102(a) of the

16. See *Camerini v. Long*, 184 Cal. App.2d 292, 8 Cal. Rptr 174 (1960).

17. *Securities & Exchange Commission v. Ralston Purina Co.*, 346 U.S. 119, 97 L.Ed. 1494, 73 S.Ct. 981 (1953).

18. For the official position of the Securities and Exchange Commission with respect to public offerings, see SEC Release No. 4552 (November 6, 1962).

act is totally new and most desirable. It eliminates one of the most meaningless gestures under the old act—obtaining a permit to issue shares in the small, closely held corporation. Basically, this section permits one to issue voting common shares in a California corporation to no more than five persons, providing the following conditions are met: the shares are evidenced by certificates which have a legend prohibiting transfer endorsed on their faces; no prospectus is used and no selling expenses are paid in connection with the issue; no promotional consideration is incurred in connection with the issue, and the consideration for the stock includes only assets, cash, cancellation of indebtedness, or, if only one shareholder is involved, any consideration; and a notice of the issue is filed with the office of the commissioner containing the facts of the issue together with an opinion of a member of the state bar that, based upon the facts contained in the notice, the offering is exempt pursuant to the section.

Other exceptions provided for in sections 25102(i) and (j) are new. Subsection (i) exempts transactions in which the offeree or purchaser is a bank, savings or loan association, trust or insurance company, investment company registered under the Investment Company Act of 1940, or, if the purchaser will own 100 percent after the purchase, any corporation with a security registered under section 12 of the Securities Exchange Act of 1934. Subsection (j) exempts sales of participating interests in oil and gas leases to purchasers who have been primarily engaged in the oil or gas business for not less than two years.

Because these subsections exempt sales to entities that are presumptively sophisticated offerees, they apparently have their genesis in the theory that such an offeree can take care of himself and need not be protected. If that is the theory, however, is it not already accommodated through the non-public offering exemption? And, if that is so, does it not make those two subsections completely redundant? Indeed, section 260.102.2 of the rules, *supra*, couples subsection 25102(i) of the act with the public offering notion by expressly stating that a public offering is not involved where the offerees are institu-

tions listed in subsection 25102(i). What then is the purpose of subsection 25102(i)? Logic would suggest that it simply be eliminated, and that more attention be paid to refining the public offering exemption.

Subsection 25102(k) exempts sales under a plan of reorganization pursuant to the National Bankruptcy Act and continues the old law.

Subsection 25102(l) exempts the sale of a call or option by a nonissuer of the security to which the call or option relates. This section is necessary because the person selling the call, even though a nonissuer in respect of the security to which the call relates, is an issuer as to the call itself.

In addition to the exemptions afforded by section 25102, the new rules create three exemptions not otherwise provided for in the act. First, section 260.105.4 exempts the sale of true franchises where the franchisor has a net worth of not less than \$500,000.00 “immediately prior to such sale or according to its latest audited balance sheet as of a date not more than 18 months prior to such sale.” The regulation specifically does not apply to those franchises which more closely resemble a true security—where the franchisee only nominally participates in the enterprise, or where his profit is based upon a pooling of the earnings of more than one franchisee. The exemption is desirable, because the extension of the old act to cover franchises was an anomaly.

The other two exemptions created by the proposed regulations are the contribution of securities to pension or profit-sharing plans¹⁹ and the issue of shares of professional corporations.²⁰

Section 25103 Exemptions. Although the exempt transactions provided in section 25103 are expressly made applicable to both normal issuer distributions under section 25110 and recapitalizations and mergers under section 25120, they largely will be applicable in transactions in the latter zone. Accordingly, they are discussed under recapitalizations and reorganizations, *infra*.

19. Rule 260.105.5.

20. Rule 260.105.6.

Methods of Issuer Qualification

Unlike the old act, which only provided for qualification by permit, the new act provides for three distinct methods of qualifying security transactions: coordination, notification, and permit. Coordination is reserved for offerings which are the subject of a registration statement under the Securities Act of 1933; notification is available for non-registered offerings involving the securities of either an issuer which has a security registered under section 12 of the Securities Exchange Act of 1934, or for an issuer which is a registered investment company under the Investment Company Act of 1940; and permit is available for any security, regardless of the availability of another form of qualification.

Coordination. Coordination represents a simplified method of qualification for issuers making a distribution subject to registration under the Securities Act of 1933. In form, qualification by coordination is widely found in other states; indeed, the new Rules expressly provide that application for coordination may be made on the *Uniform Application to Register Securities* (Form U-1) an application form developed by a sub-committee of the Committee on State Regulation of Securities of the American Bar Association.¹ Qualification is accomplished by filing a consent to service of summons and a copy of the registration statement with the office of the commissioner, together with the exhibits and an undertaking to file all future amendments to the registration statement, other than delaying amendments. If the application has been on file for not less than 10 days and a statement of proposed maximum and minimum offering prices and discounts on file for not less than 2 days, the qualification automatically becomes effective at the same time as the registration statement. The issuer must then promptly file a post-effective amendment containing the information set forth in the price amendment.

Coordination is a desirable method of qualification. Widely used in other states, it provides a method through which regis-

1. Qualification through coordination is available in approximately the same number or a variant thereof is available in excess of 30 states, with Form U-1 per-

mitted in approximately the same number.

tered offerings can be cheaply and expeditiously qualified on a national basis. Since it is only applicable to registered offerings, distributions which are qualified through it have the protection of the disclosure and anti-fraud provisions of the Securities Act of 1933, and accordingly can be handled in a more perfunctory manner by the commissioner's office. Because of the extensions of the act to cover underwritten offerings closed outside of California, not covered under the old act, coordination will probably account for the single largest increase in the business of the commissioner's office under the new law.

Notification. Notification is available to any issuer who has a security registered under section 12 of the Securities Exchange Act of 1934 or which is registered under the Investment Company Act of 1940, and when qualification by coordination is not available. Since only unregistered offerings not otherwise exempt will be qualified by notification, it probably will be limited to intra-state offerings claimed as exempt transactions under the Securities Act of 1933. Unlike coordination, which simply requires filing the registration statement and exhibits, the proposed application for notification requires detailed data with respect to the affairs of the issuer and its officers and principal shareholders. In coordination, of course, most of that data is available to the commissioner through the registration statement and exhibits.

The failure of the act and rules to provide a viable definition of "public offering" creates another potential problem in the context of qualification by notification. Private offerings exempt from registration under the Securities Act of 1933 account for an aggregate annual volume almost equivalent to registered offerings. If public offering under the California act is intended to be the same as under the federal act, then offerings exempt on that basis under the federal act and concerning partnership interests and debt will also be exempt from qualification in California. If the California concept of public offering is more rigid than the federal, then many issuers, though exempt from registration under the 1933 act, will be required to qualify such issues in California by notifi-

cation. The concept of public offer *should* be parallel under both the federal and California acts. Since most distributions of any size will be subject to both acts, a distribution exempt from one because it does not involve a public offering should not be a public offering for the purpose of the other. Although this, hopefully, is what the act intends, we are not told so; and new Rules 260.102.1 and 260.102.2 are of little help.

With respect to qualification by coordination or notification, the act also gives latitude to the commissioner in connection with the application of the standard, again stating that the commissioner *may* deny or stop-order the qualification if he determines that the proposed plan is not fair, just, and equitable. Further, the emphasis of the statute on the stop-order power of the commissioner seems to anticipate that in most instances of coordination and notification the finding will be made after the fact, if at all.

Permit. The third method of qualifying a sale of securities under the new law is by permit which substantially continues existing law. The application is made on the same form as notification but will include additional data relating to the specific form of the issue. The major distinction between qualification by permit under the new and the old law is the elimination of the express requirement that the commissioner determine that the issue will be fair, just and equitable. Rather, the act states that the “. . . Commissioner may refuse to issue a permit . . . unless he finds that the proposed issuance of securities (is) fair, just, and equitable.”² Further, apparently the act contemplates a circumstance in which such a finding is made *after* rather than before grant of the permit, since the commissioner is given the power to revoke or suspend a permit, which has been issued, upon the same grounds.³

An unusual section of the act⁴ prohibits the commissioner from making a finding of unfairness based upon the offering

2. Cal. Corp. Code § 25140(b).

4. Cal. Corp. Code § 25011.

3. Cal. Corp. Code § 25140(d).

price where the offering it registered and the subject of a firm underwriting.

Recapitalizations and Reorganizations

Section 25120 of the act continues the old practice of requiring qualification before an issuer may change the rights, preferences, privileges or restrictions of outstanding securities. Such a change is conceptually treated as a reorganization or recapitalization. Section 25120 also covers qualification of securities issued in connection with mergers, consolidations, or the sale of assets. Although section 25120 transactions are issuer transactions, section 25110, the section covering normal issuer distributions, exempts from its operation any transaction subject to section 25120.

As with issuer transactions involving the distribution of securities, the statutory scheme not only makes certain securities exempt from section 25120, but also provides a host of transactional exemptions.

Securities Exempt from Section 25120. All of those securities which are made exempt from section 25110 (normal issuer distributions) by section 25100 of the act are also exempt from section 25120, and all of the comments previously made with respect to those exemptions apply with equal force here.

One exemption that has considerably less justification when applied to section 25120 transactions as opposed to section 25110 transactions is that contained in subsection 25100(o), relating to securities listed on the New York Stock Exchange. Although the exemption can probably be justified in connection with normal distributions because the fact of the exchange listing itself assures that the issuer is of substance and fairly conducts its business and that there is an orderly market in the issuer's shares, neither of these factors seems relevant in connection with a proposed change in an existing security which substantially and adversely affects the security holder's rights.

The act is predicated on the assumption that in such a transaction the shareholder is not adequately protected by the

various corporation codes and requires administrative protection. It appears totally inconsistent with this purpose to forego regulation when the proposed transaction is subject to no other control. This would appear to be even more apparent when one considers that section 25120 only has application in the first place to proposed changes which “substantially and adversely” affect the rights or the security and when not less than 25 percent of the securities are registered in California.

Transactions Exempt under Section 25120. The transactional exemptions with respect to recapitalizations and reorganizations are found in section 25103. Although this section is also made applicable to normal issuer distributions under section 25110, most of the transactions which it contemplates will be encountered in connection with recapitalizations and reorganizations. Although the transactional exemptions found in section 25102 are limited by the act to normal issuer transactions under section 25110 and not made available to recapitalizations, proposed regulation 260.102 has extended several of them to cover recapitalizations.

Transactions Exempt under Section 25103. Subsections 25103(b) and (c) operate to exempt any transaction contemplated by issuers who have less than 25 percent of their outstanding shares owned by shareholders with addresses in California. In determining the number of outstanding shares, the issuer is required to deduct any shares to its knowledge held in “street name”, or owned by any person who directly or indirectly owns more than 50 percent of the issuer’s shares of the class to be affected.

The exemption scheme found in the balance of the section again indicates the totally different thrust of the new act. Although on its face section 25120 proscribes *all* issuer transactions involving recapitalizations unless made exempt by one of the transaction exemptions, section 25103 in turn *exempts all* recapitalization transactions unless made *not* exempt by its provisions. Accordingly, what appears as an all-inclusive proscription in fact only covers those potential areas of abuse to which it is made specifically applicable.

A weakness of section 25103 is the requirement that, to be not exempt, the transaction in the nature of a recapitalization must “substantially and adversely” affect the security holder’s rights. This *conjunctive* requirement poses two problems: (1) if the change *adversely* affects the rights of a security holder it would seem that the act should have application and that the question of the substantial nature of the change should be pertinent only to the standard to be applied by the commissioner in determining whether or not to qualify the transaction; (2) the “substantial” requirement introduces an ambiguity into the act, making for an uncertainty of application.

The specific transactions made not exempt by section 25103, with respect to *shares*, are those which substantially and adversely affect the right of any class of shareholder with respect to assessment, dividend rights, redemption provisions, liquidation preferences, conversion rights, voting rights, preemptive rights, sinking fund provisions, relative priorities, restrictions on transfer, the right of shareholders to call meetings, and the rights of shareholders of mutual water companies. The specific transactions made non-exempt by section 25103 with respect to *debt securities* are changes which substantially and adversely affect the rights of any class of security holder with respect to interest, redemption provisions, maturity date or amount payable at maturity, voting rights, conversion rights, sinking fund provisions, and subordination provisions.

The balance of the section makes *non-exempt* certain transactions involving stock splits and reverse stock splits.

Rule-created Exemptions. Although the exemptions made available to issuers in section 25102 are applicable only to section 25110 transactions, the new rules also extend certain of those exemptions to: recapitalizations; transactions not involving a public offering; transactions concerning debt, partnership interests, conditional sale and like agreements; and transactions involving mainly institutional security holders.

Qualifications of Section 25120 Recapitalizations. Unlike normal issuer transactions, the *only* method of qualification for transactions in the nature of recapitalizations and reorgan-

ization is by permit, and all of the comments with respect to that form of qualification apply here.

Nonissuer Transactions

As previously commented, one of the most significant facets of the new legislation is its extension of the state's regulatory power to cover nonissuer transactions. The definition of nonissuer transaction is any "transaction not directly or indirectly for the benefit of the issuer",⁵ and all such transactions are proscribed, unless made exempt by the act. Qualification is by either coordination or notification rather than by permit.

Exempt Securities

The act contains two categories of exempt securities with respect to nonissuer transactions: (1) those securities made exempt from both issuer and nonissuer transactions alike by section 25100, which primarily relates to securities which presumptively do not require regulation; and (2) section 25105 which relates to nonissuer transactions alone. The latter section exempts any security issued by a registered investment company under the Investment Company Act of 1940, or by an issuer of any security registered under section 12 of the Securities Exchange Act of 1934. In an almost parenthetical proviso, the section makes the exemption not applicable to registered offerings of securities issued by such companies where the aggregate offering price of the issue exceeds \$50,000. The latter is apparently predicated upon the fact that if the offering is registered and consists solely of a secondary offering of such securities, the fact of the registration must indicate that the seller is a person in control of the issuer, or otherwise in a position to easily comply with the coordination provisions of the act. If the offering is partly a primary offering by the issuer of the security and only partly a secondary offering by the nonissuer, the act contemplates that registration by coordination will be made by the issuer alone.

5. Cal. Corp. Code § 25011.

Exempt Transactions

The act exempts three basic kinds of transactions: (1) those involving what are essentially nonvoluntary distributions, such as sales by pledges and execution sales; (2) those involving isolated transactions where no advertising is involved; and (3) those involving sales to presumptively sophisticated purchasers, such as banks and other institutional purchasers. The act also exempts any transaction involving the sale of a security which has been qualified within the previous 18 months in an issuer transaction or within the previous 12 months in a nonissuer transaction.

One of the most confusing portions of the act is subsection 25104(a), which is the first of two subsections designed to permit isolated transactions by nonissuers. The language of this section is as follows:

Any offer of sale of a security by the bona fide owner thereof for his own account [is exempted from the provisions of section 25130] if the sale (1) is not accompanied by the publication of any advertisement and (2) is not effected by or through a broker-dealer in a public offering.

If one assumes that the purpose of the exemption is to permit a person owning a security to sell it in an isolated transaction not involving a public distribution of the security, subsection 25104(a) must have been intended to prohibit either a transaction in which the owner advertises and sells the security himself (on the theory that without advertising he could not possibly effect a public offering) or a transaction in which the security is sold by a broker-dealer in a public offering. The unfortunate use of the conjunctive "and", however, has resulted in exempting the transaction in which the owner effects a public offering *through* a broker-dealer, as long as the *broker-dealer* does not advertise. And, if the language of subsection 25104(a) is taken at face value, the exemption would also be available to the nonissuer even though he effects a public offering *and advertising*, so long as he does not utilize the services of a broker-dealer.

The exemptions in subsection 25104(b) concerning a transaction effected through a broker-dealer pursuant to an unsolicited order or offer to buy, is a familiar one in securities legislation. The theory is that where the purchaser, without any prompting, determines to purchase a security, any deficiency in it is his business alone.

Another unusual exemption is subsection 25104(c), exempting the sale by a nonissuer to a bank, insurance company, registered investment company, or other institutional purchaser. Although there is nothing unusual about exempting sales to sophisticated purchasers, what is unusual is the condition that the seller acquire an investment representation in connection with the transaction since the purchaser is in turn subject to all of the nonissuer provisions of the act. And, if the purpose of subsection 25104(c) is to prevent a public distribution, how does one explain subsection 25104(a)?

Qualification of Nonissuer Transactions

The act provides two methods of qualification with respect to nonissuer transaction: coordination and notification. Coordination, as in the case of issuer transactions, is available where the offering is being made pursuant to a registration statement under the Securities Act of 1933. If the nonissuer transaction is coupled with a primary offering by the issuer, the offering is, for the purpose of qualification by the nonissuer, treated as solely an issuer transaction pursuant to section 25011 of the act. Accordingly, qualification in that circumstance is done by the issuer alone.

Qualification by notification is similar to that used in connection with issuer transactions, although done under the aegis of section 25131, rather than section 25112.

Prohibited Practices

The act includes a number of provisions designed to prevent market manipulation and the fraudulent sale of securities; for the latter purpose, the act incorporates substantially all of Rule 10B-5(2) of the Securities Exchange Act of 1934. Perhaps the most interesting of the new provisions is section

25402, apparently designed to eliminate the kind of practice encountered in *Texas Gulf Sulphur*.⁶ The text of the section is as follows:

It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationships which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.

One potential ambiguity with respect to the section is caused by the phrase “whose relationship to the issuer gives him access, directly or *indirectly*, to material information about the issuer not generally available to the public. . . .” Although “indirectly” is obviously intended to modify “access”, is it also intended to modify “relationship”? The question becomes important in the context of the purchaser (or seller) of a security who has based his acquisition on a tip received from an employee of the issuer who indirectly has access to information not available to the public. Obviously, the employee would be liable under the section had he made the acquisition because the information was indirectly received through his relationship to the issuer. Is the “tippee” also liable? To say yes would create an extension of insider liability not yet reached by the courts under Rule 10B-5. To say no, however, would probably render the language of the section redundant, for the adoption of the language of Rule 10B-5(2) must certainly result in the adoption of the gloss placed on that language by the cases decided under the Securities Exchange Act of 1934.

6. S.E.C. v. Texas Gulf Sulphur Co.,
401 F.2d 833 (2d Cir. [1968]).