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Regulation and Civil Liability Under the California Corporate Securities Act

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INTRODUCTION

THIS article deals primarily with the general scope of regulation, and the question of civil liability, under the California Corporate Securities Act.¹ It does not purport to cover the general question of administrative justice under the Act,² or such specific questions as

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¹The first California "blue sky law," which was known as the "Investment Companies Act," was enacted in 1913, approximately two years after Kansas enacted the first blue sky law in the United States (Cal. Stats. 1913, c. 353, p. 715). Following the United States Supreme Court's decision that blue sky laws are constitutional (Hall v. Geiger-Jones (1917) 242 U.S. 539, 37 Sup. Ct. 217), the Investment Companies Act was replaced in 1917 by the reframed CORPORATE SECURITIES ACT (Cal. Stats. 1917, c. 532, p. 673) which became effective July 27, 1917.

²It is believed that the California Bar generally would readily acknowledge that the Division of Corporations has been one of the model statewide regulatory agencies. For years the Division has had a fairly comprehensive code of rules and regulations which is readily available to the public. It has, generally speaking, exercised its rule making power only after notice and opportunity for interested parties to present their views; its hearing officers have generally been trained lawyers; and its disciplinary and adjudicatory proceedings have complied with the rudimentary due process requirements of adequate notice and full opportunity for hearing. It is probable that the adoption of the reforms in administrative procedure which are now being so vigorously agitated, both in the nation and the state, would effect very little change in the administrative procedure of the Division. In the main the Division has complied with the minimum standards prescribed both in the proposed Federal Administrative Procedure Act sponsored by the Special Committee on Administrative Law of the American Bar Association, and in the Administrative Procedure Act which was submitted to the 1945 California Legislature by the Judicial Council of California in the form of Senate Bill No. 705. (This bill was signed by the Governor on June 15, 1945. SEN. BILL 705; Cal. Stats. 1945, c. 867.) See Kleps, *California's Approach to the Improvement of Administrative Procedure* (1944) 32 CALIF. L. REV. 416, as to the background of this latter legislation.

exemptions, administrative procedure, the rule making power of the Commissioner of Corporations, judicial review, or criminal liability under the Act, although all these subjects are, of necessity, frequently alluded to throughout this article for purposes of illustration.

The California Corporate Securities Act marks a radical departure from common law principles. It is a legislative attempt to repair the deficiencies of the common law in the field of security transactions, by providing regulation of substantially the entire field of security sales transactions—original issues, secondary sales, and broker and dealer activities. While the Act outlaws extensive fields of conduct, nevertheless it is almost wholly silent as to questions of civil liability arising out of violations of the Act, including such questions as persons who are liable, the nature and scope of liability for violations, defenses and quantum of recovery. Nor is any express provision made as to the classes of persons to whom the right of recovery runs. The Act even fails to prescribe any period for the limitation of actions. All these troublesome and vexatious questions are left entirely to judicial interpretation.

It is natural that the courts, in construing the provisions of the Act, have been greatly influenced by common law principles. Many of the anomalies and much of the confusion found in the cases undoubtedly spring from the tendency of the Anglo-American legal mind to think in terms of procedure and from its enslavement to old terms and the old doctrines of deceit, negligence and warranty.³

The seemingly hopeless confusion in the cases arising under the Act as to the nature and scope of civil liability, would be almost wholly incomprehensible except in view of the background of the common law. To paraphrase Cardozo, the decisional law construing the Act has been built upon a substratum of common law. Unfortunately, the analogies employed are not quite perfect, since the Act would appear clearly to be designed by the legislature to create wholly new formations of liability. Liability under the Act is not in essence a liability for deceit or fraud since scienter, reliance, materiality and causation are almost wholly irrelevant. Moreover, the liability is not a true extension of the idea of warranty. While it has some of the elements of warranty, in that it is an absolute liability and scienter is immaterial, nevertheless it would appear not to be subject to the same limitations as the doctrine of warranty since the liability attaches to

³ Cf. Bohlen, *Misrepresentation as Deceit, Negligence or Warranty* (1929) 42 HARV. L. REV. 733.

persons who are not parties to the sale and, moreover, runs to successive purchasers.

That the questions of civil liability under the Act cannot be satisfactorily explained solely by common-law concepts has become clear by the experience derived from the Federal security acts. During the period when the Securities Act of 1933 and the Securities Exchange Act of 1934 were under consideration and following their passage, there was a critical nation-wide re-examination of the whole law of securities, which has led to a much clearer and more concise definition of terms and understanding of the nature and scope of civil liability in the security field.

The Securities Act of 1933 and the Securities Exchange Act of 1934, unlike the Corporate Securities Act, purport to cover every phase of the respective fields they are designed to regulate, including civil liability. Each of the acts, of course, has different liability sections applying to different situations. Thus, Section 11 of the Securities Act of 1933 differs widely from Section 12 of that Act. But, generally speaking, both acts expressly deal with such questions as scienter, reliance, nature of remedy, quantum of recovery, limitations of actions, and questions as to the various persons to whom liability attaches and those to whom the right of recovery runs. Thus, Section 11 of the Securities Act of 1933 permits any person acquiring the security to sue and abolishes the common-law requirement of privity, whereas Section 12 retains that requirement and permits a person to sue only his immediate vendor.

The Federal security acts of course do not govern in any way the proper interpretation of the California Corporate Securities Act. None of the liabilities which they impose supplants any common-law or other remedy. Nevertheless, the nationwide scrutiny of the entire field of security law which preceded and followed the enactment of the Federal acts has undoubtedly led to an infinitely better comprehension of the problems involved, and has thereby been of great aid in the proper understanding of the California Corporate Securities Act itself.

General Purposes of Act

The blue-sky laws of the various states differ widely.⁴ Some are

⁴ Various attempts have been made to classify these laws into various types according to the objectives sought and the means employed for obtaining such objectives. See, for example, Dalton, *The California Corporate Securities Act* (1930) 18 CALIF. L. REV. 115; Smith, *The Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP.

merely designed to prevent fraud; others are more paternalistic and seek to go much further in protecting the investing public against its own speculative folly in cases where there is no fraud or concealment. Aside from the simple "fraud" type of law, which merely provides penalties for fraud and authorizes injunctive proceedings to prevent fraud, the various statutes seek to accomplish their objectives by one or both of the two following means, namely: qualification of the security itself; and dealer regulation.

Security qualification is provided in one of two alternative manners, either by registration by the issuer or by the dealer or by either; or by affirmative authorization by a state regulatory body, usually in the form of a permit which is ordinarily based on the application of the issuer.

Dealer regulation is usually accomplished by a requirement that the dealer be licensed, such requirement usually being supplemented by a variety of other powers over dealers vested in the regulatory agencies, such as power to supervise advertisements and circulars, issue stop orders and prohibit further sales of securities.

The California Corporate Securities Act falls in the class of statutes which require both that securities be qualified and that dealers be licensed. Securities are qualified under the Act by permit of the Commissioner of Corporations granted upon application of the issuer, and all dealers (and brokers and agents) are required to be licensed. The provisions of the Act, although not formally so divided—are

PROB. 241; Smith, *State Blue Sky Laws and the Federal Securities Acts* (1936) 34 MICH. L. REV. 1135; Note (1938) 11 SO. CALIF. L. REV. 345-347; *A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act*, prepared by the Department of Commerce, appearing in HEARING BEFORE A COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE OF HOUSE OF REPRESENTATIVES ON H. R. 4314.87, 73d Cong., 1st Sess. (1933), reprinted in C. C. H. SECURITIES ACT SERVICE 25.

Smith in his article on Blue Sky Laws, cited above, classifies the various state laws as follows:

(a) The "fraud" type, which does not require either security qualification or the licensing of dealers, but merely provides penalties for fraud and authorizes injunctive proceedings to prevent fraud. (The New York act, generally known as the "Martin Act," is a modified fraud type of law since it also requires the registration of dealers who are required to file certain statements and notices with the Department of State and the Department of Law.)

(b) The "licensing" type of law, which requires dealers in securities to be licensed but does not require that the securities themselves be qualified.

(c) The "securities qualification" type of law, which requires that securities be qualified but does not require that dealers be licensed.

(d) The "securities qualification and licensing" type of law, which requires both that securities be qualified and that dealers be licensed.

separable into two wholly different parts, directed, respectively, to these two main purposes, namely: security qualification and dealer regulation. These two main parts⁵ of the Act, while complementary, serve entirely separate purposes and cover wholly different fields. For convenience, throughout this article, the part of the Act relating to security qualification is referred to as the "permit provisions" of the Act; and the part of the Act governing dealers⁶ is referred to as the "dealer regulation provisions."

Permits are required to be obtained only in connection with newly issued nonexempt securities. Only the issuer is required to obtain a permit. A dealer is not required to obtain a permit or to "qualify" the security itself either by registration or otherwise.⁷ In this respect the California law differs radically from that of Michigan, Minnesota, Wisconsin and other states.

The permit provisions of the Act are designed to cover, in general, the same field, though by a different method, as that covered by the Securities Act of 1933 which (except for the provisions of its anti-fraud section, Section 17) relates only to new offerings.

The broad purpose of the Securities Act of 1933 is to protect buyers of *newly issued* securities by requiring complete and accurate disclosure. Except for its anti-fraud Section 17 (which is a supple-

⁵ The Act contains other provisions not dealt with in this article which are ancillary or incidental to its permit provisions and dealer regulation provisions—chiefly those relating to the licensing of investment counsel. Moreover, it is to be noted that various other statutes confer extensive regulatory powers on the Commissioner of Corporations in certain related fields (*e.g.*, BUCKET SHOP ACT, Cal. Stats. 1923, c. 226, p. 449; STOCKHOLDERS PROTECTIVE COMMITTEE ACT, Cal. Stats. 1937, c. 784, p. 2232; and THE RETIREMENT SYSTEMS ACT, Cal. Stats. 1945, c. 1035, p.); and in other fields which are related, if at all, only remotely to the securities field (*e.g.*, PERSONAL PROPERTY BROKERS ACT, Cal. Stats. 1909, c. 634, p. 969, as amended; CALIFORNIA SMALL LOAN ACT, Cal. Stats. 1939, c. 953, p. 2679, as amended; INDUSTRIAL LOAN ACT, Cal. Stats. 1941, c. 1187, p. 2945, as amended; and CREDIT UNION ACT).

⁶ The Act has never contained an independent definition of the term "dealer," nor does it in express terms distinguish between a "broker" and a "dealer." However, the term "broker" is defined in the Act to include persons who are dealers as well as brokers in the strict sense. Generally speaking, a "dealer" is a person engaged in the business of buying and selling securities issued by others as a principal for his own account. A "broker" is a person engaged in the business of effecting transactions in securities for the account of others.

⁷ For a relatively short period commencing August 1, 1930, the Corporation Commissioner, acting under his "rule making" power but without any express statutory power authorizing him so to do, purported to require "stock brokers" dealing in securities, even though personally owned, to have such securities "approved for trading" by the Commissioner. See Rule 26, effective August 1, 1930, and Rule 23, effective August 1, 1931.

ment to the state blue-sky laws and prohibits fraud in the sale of any security whether newly issued or not and regardless of whether it is exempted from the registration provisions of the Act), the Securities Act of 1933 has no application to securities issued prior to the passage of the Act. It is purely a registration act. After full disclosure is made, the Securities and Exchange Commission cannot impose conditions or prevent sale. The commonly stated objective of the Act is to require complete and accurate disclosure to prospective purchasers of all material facts relative to securities to be offered for sale to the public and to prevent fraud in their distribution or sale.

The California Corporate Securities Act is not a registration act but a specific permit act. It goes far beyond the disclosure theory of the Securities Act of 1933, and it also reaches far beyond the prevention of fraud. It is designed to prevent deception, the exploitation of ignorance, and all unfair dealings in the issue of securities. The Act gives the Commissioner broad discretionary, administrative power to impose conditions⁸ or even deny issuance of a permit in any form⁹ if he deems the issuance of the securities would be unfair, unjust or inequitable.

The dealer regulation provisions of the Act are comparable in a general way in their objectives with the Securities Exchange Act of 1934. The purpose of such provisions is to regulate *resales of validly issued and already outstanding securities* by regulation of dealers, brokers and agents, in contrast to the permit provisions of the Act which relate solely to *new issues* as does the Securities Act of 1933 (except as to resales of outstanding securities by "controlling persons"). The Securities Exchange Act of 1934 seeks to accomplish its objectives by requiring registration of exchanges and securities, reports by companies whose securities are listed on national securities exchanges and by the exchanges themselves, and by regulating credit, proxies, dealings by insiders and manipulation. It also enters the field of dealer regulation by requiring the licensing of dealers engaged in over-the-counter market transactions.

The broad difference between the permit provisions of the California Corporate Securities Act, which apply only to original issues, and the dealer regulation provisions of the Act, which apply to the field of resales of securities, is loosely comparable to the difference between the Federal stamp tax law relating to original issues of stock

⁸ *Agnew v. Daugherty* (1922) 189 Cal. 446, 209 Pac. 34.

⁹ *Otten v. Riesener Chocolate Co.* (1927) 82 Cal. App. 83, 254 Pac. 942.

and that relating to sales and transfers of stock (Subsections (a) and (b) respectively, of Section 1802 of the Internal Revenue Code). However, it is of course dangerous to pursue too closely analogies from the field of tax law.¹⁰

It is of passing interest to note that no part of the California Corporate Securities Act makes any attempt expressly to regulate *purchases* of securities. In this state unfair dealings in the purchases of outstanding securities, whether by so-called "insiders," such as officers, directors or dominant stockholders, or by dealers, brokers or others, can be reached only by the application of common-law principles, and to a somewhat undefined extent by disciplinary measures initiated by the Corporation Commissioner against licensed dealers.

The Securities Act of 1933 similarly regulates only sales of securities, even under the broad anti-fraud provisions contained in Section 17.

In contrast, the Securities Exchange Act of 1934 is designed to regulate trading in securities—either in the *purchase* or sale of securities—in national securities exchanges and in over-the-counter markets.¹¹

DETAILED ANALYSIS OF PERMIT PROVISIONS OF ACT

Before proceeding to an analysis of the specific problems of civil

¹⁰ Simple stock split-ups, and recapitalizations not involving any increase in capital are not subject to stamp tax as original issues, but would be considered such under the Corporate Securities Act and would require a permit.

¹¹ The problem of deception on the *seller* of securities has only recently attained importance. The limits of legal liability on the buyer of securities for unfair dealings have by no means as yet been fixed, but there is a clearly marked tendency on the part of the Securities and Exchange Commission—and even some courts—to extend liability to buyers of securities under certain circumstances of non-disclosure and exploitation of ignorance that clearly fall short of common law fraud. The Securities Exchange Act itself, §16, only expressly prohibits abuse of trading based on inside information by penalizing quick profits from short term market fluctuations. *Cf.* *Chenery Corporation v. Securities & Exchange Commission* (1942) 128 F. (2d) 303, 310, 318 U.S. 80. The Securities and Exchange Commission's Rule X-15C1-2, adopted pursuant to Section 15(c) of the Securities Exchange Act of 1934 (over-the-counter markets) and its even broader Rule X-10B-5, evince a clear policy to extend corrective action for the protection of sellers of securities against purchasers possessing superior knowledge. See S. E. C. RELEASE 3445 (June 12, 1943) REPORT ON INVESTIGATION IN IN THE MATTER OF THE PURCHASE AND RETIREMENT OF WARD LAFRANCE TRUCK CORPORATION CLASS "A" AND CLASS "B" STOCKS; and *cf.* address of Edward H. Cashion, Counsel to the Corporation Finance Division, S. E. C., *Fraud on the Seller of Securities*, delivered at St. Louis, Mo., December 13, 1944, before the National Association of State Securities Commissioners.

liability under the permit provisions of the Act, it is essential to determine the basic rule as to requirement of a permit and to examine the basic questions of what constitutes a "security," what constitutes an "issue" of securities, and other related problems.

Basic Rule as to Requirement of a Permit

The basic rule under the Act is that a permit is required only in connection with an original issue of non-exempt securities by an issuer. No permit is required for the resale (except by the issuer itself) of any outstanding security theretofore validly issued either in California or elsewhere.

The heart of the permit provisions of the Act appears in Section 3, which at all times has provided as follows:

"No company shall sell . . . or offer for sale, negotiate for the sale of or take subscriptions for any *security of its own issue* until it shall have first applied for and secured from the commissioner a permit authorizing it so to do."

This section must be read in conjunction with the voiding section of the Act (Section 16) which only voids securities *issued* in violation of the permit provisions of the Act. No "sale" other than an original issue, in violation of the provisions of the Act, renders the security itself void, even though such sale might be illegal.

The prohibitions of the permit provisions of the Act are directed against the *issuer*, including, of course, its agents and persons aiding it or acting in its behalf. The word "company" in the permit provisions of the Act is synonymous with the word "issuer," and by statutory definition includes corporations, partnerships, trustees and certain individuals, as hereinafter more fully discussed.

A dealer or individual not acting for the *issuer* need not obtain a permit to sell personally owned securities issued by others. In this respect, the California law, as already noted, differs radically from that of some other states requiring "specific approval," such as Michigan, Minnesota and Wisconsin.¹² In California, the security to be approved by permit is the security *issued* by a company ("issuer"); in other states in the class of those mentioned, the security to be approved is any security *sold* by an issuer, or dealer, broker or other person.

The permit provisions of the California Act, in contradistinction to the Federal Securities Act of 1933 and the blue-sky laws of many

¹² Dalton, *The California Corporate Securities Act (1930)* 18 CALIF. L. REV. 115.

other states, are essentially directed against the *issue of new securities*. The emphasis is not on sales. The Act requires a permit for every *issue* of non-exempt securities in California, even though no true sale is involved. Under the Act the term "issue" has a much broader meaning than the term "sale" in its ordinary connotation. Every original sale by an issuer is an issue, but every issue does not constitute a sale. Numerous instances could be cited to illustrate the difference. Thus a simple split up of outstanding shares requires a permit under the Act,¹³ although it is clear that such split up does not involve a true sale. Again, the Act as construed by the Division of Corporations requires a permit to be obtained for the issue of share dividends by a California corporation (or by a foreign corporation with its commercial domicile in California) although, according to the preponderance of opinion, a share dividend does not involve a "sale."¹⁴ The Act also requires a permit for securities issued to existing security holders in exchange for outstanding securities of the issuer; and in connection with statutory mergers and consolidations even though under generally recognized authorities no "sale" is involved in a statutory merger or consolidation.¹⁵

¹³ The Act recognizes the purely formal nature of a stock split-up in the fee section, in that it provides that the fee for filing a permit for such split-up is only \$25, regardless of the value of the shares involved. (§26.12.)

¹⁴ The exemption of share dividends and related distributions by the issuer in the early drafts of the Federal Securities Act of 1933 was eliminated as unnecessary in view of the fact that such distributions, not being made for value, did not involve sales. H. R. (CONF.) REP. NO. 152, 73d Cong., 1st Sess. (1933) 25. See Throop and Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 89, 113. If a cash dividend is declared concurrently with an increase in stock and an option granted to the stockholder to apply the dividend toward the purchase of stock, it is obviously a "sale" if the option is exercised, since the stockholder becomes a creditor—he has received something of value severed from the corporation—and in exercising his option he furnishes the consideration for the sale by a cancellation of pre-existing indebtedness. However, in the case of a true stock dividend the stockholder does not become a creditor; he has no option or even power of any kind; he does not accept any "offer." While such a dividend results in a capitalization of surplus, it "really takes nothing from the property of the corporation." (*Eisner v. Macomber* (1919) 252 U.S. 189, 40 Sup. Ct. 189.) It is a mere split-up of the original investment into smaller units. The stockholder furnishes no consideration, and a true stock dividend does not constitute a "sale." See, generally, MAGILL, *TAXABLE INCOME*, c. 2, on Corporation Distributions.

¹⁵ The Securities and Exchange Commission, in its Rules as to the Use of Form E-1 for the registration under the Securities Act of 1933 of securities issued in reorganization, has ruled that the Commission deems no "sale" is involved in the issuance of securities in a statutory merger or consolidation. See Note to Rule 5(2). This view was sustained by the 9th Circuit Court of Appeals in the case of *National Supply Co. v. Leland Stanford Jr. University* (1943) 134 F. (2d) 689 (*cert. den.*, 320 U.S. 773, 64 Sup. Ct. 77)

It is to be observed, however, that the Act contains a factitious definition of the term "sale," especially since the ill-advised amendment by the 1945 Legislature which broadened the definition to include "any change in the rights, preferences, privileges or restrictions on outstanding securities . . ."¹⁶ This amendment sweeps not merely adverse changes under the regulation of the Commissioner of Corporations, but also every change of preferences or restrictions even though such changes are beneficial to the class of securities affected. This, for all practical purposes, will mean that substantially every charter amendment affecting outstanding securities will require a permit. Thus, if a sinking fund is provided *de novo* for outstanding preferred stock, or the annual obligation of an existing sinking fund is increased, a permit will be required on the theory that a "sale" of securities is involved. To denominate practically every charter amendment a "sale" of securities and subject the transaction to a permit requirement under the Act appears highly artificial, and will undoubtedly lead to absurd and onerous results that the Legislature could not have envisaged.¹⁷ It is, of course, competent for the Legislature to include practically anything in a definition,—no matter how logically absurd the result might be,—as illustrated by the old statute which defined "horses" to include cows and sheep. Nevertheless, it seems a distortion of the term "sale" in connection with securities, to include within its meaning every charter amendment affecting outstanding securities.

It is true that the courts have differentiated between a *sale* and an *issue*, as those terms are used in the Act,¹⁸ and there are general statements in some of the decisions to the effect that "it is the act of *selling* that is principally placed under the examination of the Commissioner of Corporations."¹⁹ Nevertheless, it would appear clear, in view of the voiding section of the Act, that it is the original issue in violation of the permit provisions of the Act that is all-important

in which the Circuit Court held that securities issued in a statutory consolidation do not involve a "sale" or an exchange amounting to a sale. *Cf.* also Smith, *Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP. PROB. 241, 249.

¹⁶ Cal. Stats. 1945, c. 399, amendment of §2(a)8 of the CORPORATE SECURITIES ACT. (Emphasis supplied.)

¹⁷ The Legislature attempts to soften the blow of requiring a permit for every charter amendment affecting outstanding securities by fixing a filing fee for a permit in such case of only \$25, regardless of the amount of securities involved. (§26.12 of the Act.) Nevertheless, it is feared that many lawyers will overlook the 1945 amendment and neglect to obtain permits in cases of many charter amendments with the result that the securities "issued" pursuant to such amendments will technically be void.

in determining whether the security itself is void. The consequences of civil liability are radically different in the case where the security itself is void in contrast to the case in which only the transaction is illegal but the security itself is not void.

The complete coverage of the permit provisions of the Act over every issue of nonexempt securities is also illustrated by the fact that the Act applies to a single transaction, even though at private sale where there is no public offering.²⁰

Preliminary transactions prior to issue.

The prohibitions of Section 3 of the Act expressly apply to offers, negotiations, subscriptions, executory contracts, and other preliminary acts leading up to the final act of performance—they are not limited to the issue of the security or actual “transfer of title” alone.

Some of the most troublesome and controversial problems arising under the Act revolve around these provisions. At the outset it is believed that three preliminary observations are of aid in considering these problems.

In the first place, it is to be noted that the prohibitions of Section 3 are aimed exclusively at the *issuer*, including, of course, any agent or other person acting on behalf of the issuer. However, the courts are quick to hold a promoter to be the *alter ego* of the issuer, or, where necessary to circumvent fraud, to hold the seller himself to be an issuer. On the other hand, the prohibitions of the section are not leveled at buyers²¹—or at duly licensed dealers not acting as agents for the issuer.²²

Secondly, in the inherent nature of things, there are innumerable situations where preliminary offers and executory contracts for the issue of securities are made before any application for a permit is

¹⁸ *Otten v. Riesener Chocolate Co.* (1927) 82 Cal. App. 83, 254 Pac. 942 (sup. ct. *hear. den.*); *Reno v. American Ice Machine Co.* (1925) 72 Cal. App. 409, 237 Pac. 784 (sup. ct. *hear. den.*); *People v. Oliver* (1929) 102 Cal. App. 29, 282 Pac. 813; *Duntley v. Kagarise* (1935) 10 Cal. App. (2d) 394, 52 P. (2d) 560; *Miller v. California Roofing Co.* (1942) 55 Cal. App. (2d) 136, 142, 130 P. (2d) 740, 744.

¹⁹ *People v. Oliver*, *supra* note 18.

²⁰ *Domestic & Foreign Pet. Co. v. Long* (1935) 4 Cal. (2d) 547, 51 P. (2d) 73; *Cecil B. deMille Productions v. Woolery* (1932) 61 F. (2d) 45 (C.C.A. 9th, 1932).

²¹ *Robbins v. Pacific Eastern Corp.* (1937) 8 Cal. (2d) 241, 284, 65 P. (2d) 42, 63 (acceptance by buyers in California or appointment by buyers in California of agent to receive securities in another jurisdiction not illegal).

²² OPINION OF ATTORNEY GENERAL, dated June 17, 1919, holding that a licensed broker [dealer], that is, one dealing in securities issued by another, may offer to sell to the public, as and when issued, securities subject to supervision of the Commissioner, *before* such securities have been authorized to be issued by the Commissioner.

filed. Thus executory contracts are entered into between the issuer and an underwriter; or, in the case of the organization of a new corporation where property is to be transferred to it in exchange for its securities, the promoters generally make the offer before any application for permit is filed. Where such offers and executory contracts are expressly made subject to approval of the Commissioner of Corporations—which is always done in good practise—and a permit for the issue of the securities is subsequently obtained, neither the Division of Corporations nor the Bar generally is concerned with any question of preliminary technical violation. Generally in such instances only an application for a definitive permit is made, and only in rare instances is application made for a so-called “offering” permit.²³

Thirdly, the courts have made a pragmatic approach to the problems relating to preliminary transactions. They have been more concerned with just results than with logical consistency. Viewed practically, the seemingly hopeless conflict and confusion in the cases largely disappears.

Prohibited preliminary acts of the issuer are illegal even though the securities are to be issued at a future date,²⁴ or are subsequently validly issued,²⁵ or the sale is to be consummated outside the state,²⁶ or even though no sale is consummated as the result thereof.²⁷

Thus, subscription agreements, promissory notes and other executory contracts executed before the obtaining of a permit are illegal. In many of the cases involving preliminary acts, the transaction halts short of an actual issue of the security and such cases generally involve only the original parties to the transaction. In all such cases, unless the rights of third parties intervene,²⁸ the courts hold the transaction illegal and either award the buyer affirmative relief or allow him to set up the illegality of the transaction as a defense.

Of course, if securities are actually issued in violation of the Act

²³ A permit “to negotiate for the sale of securities” is usually granted on an informal basis and, moreover, the fee section of the Act (§26.9) requires only a fee of \$15 for the filing of an application for such a permit, regardless of the size of the proposed issue. Such “offering” permits are obtained solely for the purpose of legalizing preliminary acts by the issuer and its agents.

²⁴ *Reno v. American Ice Machine Co.* (1925) 72 Cal. App. 409, 237 Pac. 784; *People v. Oliver* (1929) 102 Cal. App. 29, 282 Pac. 813.

²⁵ *Miller v. California Roofing Co.* (1942) 55 Cal. App. (2d) 136, 130 P. (2d) 740.

²⁶ This rule was assumed in the decision in the Robbins case, *supra* note 21.

²⁷ *Cf. People v. Augustine* (1925) 232 Mich. 29, 204 N.W. 747.

²⁸ Thus, it has been held that a negotiable note in the hands of a *bona fide* purchaser for value is not subject to the defense that it was given for securities sold in violation of the Act. *Pitman v. Walker* (1922) 187 Cal. 667, 203 Pac. 739.

or as a direct result of prohibited preliminary acts, more far-reaching legal consequences ensue since the securities themselves in such case are void, and even successive assignees and third persons not parties to the original transaction are entitled to redress.

However, illegal preliminary acts do not of themselves render the security itself void. It is only the issue in violation of the Act which has such effect. The Act does not use the word "void" in any other connection.²⁹ Various cases recognize that the final act of performance by delivery of the security may be valid despite prior illegal preliminary acts. This doctrine is of special importance in situations where foreign corporations are involved.³⁰ It also applies even in cases where all steps in the transaction occur in California and even though a domestic corporation is involved. The rule, while difficult of application in certain situations, is simply stated in the leading case of *Moore v. Moffatt*,³¹ and in the case of *Waring v. Pitcher*.³² In each of these cases there had been a prior illegal subscription agreement but performance by delivery of the certificates occurred after the permit was obtained. In each case it was held that the final transaction was sufficiently independent and disconnected from the prior illegal transaction to constitute a legal act. Under the doctrine announced in *Moore v. Moffatt*, the final performance must not grow directly on the stem of the prior illegal preliminary act—there must be some break or departure from preceding acts to constitute the final act of performance a new or independent transaction as of the time of performance.³³ In such cases, the final act is not a ratification, in the proper sense of that word, of a prior illegal contract since it is clear

²⁹ Cf. *Miller v. California Roofing Co.* (1942) 55 Cal. App. (2d) 136, 142, 130 P. (2d) 740, 744.

³⁰ See *Robbins v. Pacific Eastern Corp.* (1937) 8 Cal. (2d) 241, 65 P. (2d) 42. This topic will be covered in a subsequent installment.

³¹ (1922) 188 Cal. 1, 204 Pac. 220.

³² (1933) 135 Cal. App. 493, 27 P. (2d) 397.

³³ It has been stated that the doctrine announced in *Moore v. Moffatt* "is intended to be an exception to the general rule, and applies only to those situations in which a representative of creditors is attempting to recover from parties to whom stock has been issued without full payment, or the rights of innocent third parties intervene." *California Western Holding Co. v. Merrill* (1935) 7 Cal. App. (2d) 131, 151, 46 P. (2d) 175, 185, cited in *Miller v. California Roofing Co.*, *supra* note 29. It is significant that the latter case, although decided several years subsequent to the Robbins case by the California supreme court fails to cite or attempt to distinguish that case. It is believed that this explanation is an over-simplification. See *infra*, under the caption Securities Issued by Foreign Corporations Outside the State.

³⁴ *Walker v. Harbor Realty Etc. Corp.* (1931) 214 Cal. 46, 3 P. (2d) 557.

that there can be no such ratification.³⁴ But while there can be no technical ratification of a void contract, there may be a subsequent valid new contract on the same subject, and such new contract is not tainted by the earlier illegal contract.³⁵

In short, the rule as to preliminary illegal transactions is applied pragmatically. In cases where there is a clear absence of fraud or intent to evade the Act, the courts have sustained the validity of subsequently issued securities despite prior technical preliminary violation. Moreover, preliminary technical violations are frequently condoned at the administrative level. It is well known that the Division of Corporations has repeatedly issued permits despite prior innocent technical illegal preliminary acts where it has been convinced that there was good faith and a total lack of fraud or overreaching.

However, in every case where there is actual fraud, or even exploitation of ignorance short of fraud, or an intent to circumvent the act, neither the regulatory agency nor the courts are at all impotent to correct illegal preliminary acts.

What constitutes a "security."

The Act has always contained a comprehensive definition of a "security," although such definition is by enumeration. Since 1929 the definition has been substantially the same as that contained in the Act today, the only difference being that the present definition expressly includes a guarantee of a security and a certificate of deposit for a security.

Section 2(a)7 of the Act defines a security as follows:

"The word 'security' shall include any stock, bond, note, treasury stock, debenture, evidence of indebtedness, certificate of interest or participation, certificate of interest in a profit sharing agreement, certificate of interest in an oil, gas or mining title or lease, collateral trust certificate, any transferable share, investment contract, or beneficial interest in title to property, profits or earnings, guarantee of a security and any certificate of deposit for a security."

The term "security" under the Act includes not only well recognized types of corporate securities, but other "interests" whether issued by corporations, trustees, partnerships, or individuals.

There is generally no difficulty in recognizing the true nature of a share of corporate stock, or a bond or debenture, or other corporate

³⁵ Cf. *Bauer v. Bond & Goodwin, Inc.* (1934) 285 Mass. 117, 188 N.E. 708; 3 WILKINSON ON CONTRACTS, §1707, p. 4824 (Sunday contracts).

securities. The difficulties arise chiefly when other "interests," and issuers other than corporations, are involved.

At the outset it is to be emphasized that the question of what constitutes a security is not a question of fact, but one of law upon which the courts alone can pass.³⁶ Consequently, a finding by a trial judge or a jury that a given interest does not constitute a "security" would not be binding. Moreover, a determination by the Commissioner as to what constitutes a security has no administrative finality. Nevertheless, it is believed that the California courts have never rejected, as an erroneous interpretation of law, any such administrative determination of what constitutes a security.

In considering what constitutes a security, the courts look through form to substance and are as quick in this field as they are in the field of taxation,³⁷ to unmask any disguising of the true nature of a transaction to discover its real character.³⁸

While the courts are generally loath to attempt to define with any degree of finality a term such as "security," it is clear that there has been an unmistakable trend in the California decisions to interpret the Act liberally and to sweep almost every conceivable sort of interest within the definition.³⁹ While some of the distinctions made by the courts seem almost metaphysical in refinement, they illustrate the ease with which the courts expand the definition of the term "security"; especially whenever fraud needs to be redressed.

One of the earliest cases laid down a very sweeping—and very vague—definition in the following language: "If the instrument of sale creates a present right to a present or future participation in either the income, profits or assets of a business carried on for profit, it is a security as defined in the Corporate Securities Act."⁴⁰

Securities are so protean in form that it would appear impossible

³⁶ *People v. McCalla* (1923) 63 Cal. App. 783, 220 Pac. 436.

³⁷ *Cf. Gregory v. Helvering* (1934) 293 U.S. 465, in which the United States Supreme Court announced the well known doctrine that a colorable transaction used for the purpose of tax evasion, though perfect in paper form, will not be recognized by the courts. In *Brock & Co. v. Board of Supervisors* (1937) 8 Cal. (2d) 286, 65 P. (2d) 791, the California supreme court applied the same doctrine. In *Commissioner v. Ashland Oil & Ref. Co.* (C.C.A. 6th, 1938) 99 F. (2d) 588, it was stated, "It has been said too often to warrant citation, that taxation is an intensely practical matter, and that the substance of the thing done and not the form it took must govern."

³⁸ *People v. Craven* (1933) 219 Cal. 522, 27 P. (2d) 906; *Domestic & Pet. Co. v. Long* (1934) 4 Cal. (2d) 547, 51 P. (2d) 73.

³⁹ See Notes, 28 CALIF. L. REV. 410; 10 So. CALIF. L. REV. 483.

⁴⁰ *People v. Oliver* (1929) 102 Cal. App. 29, 36, 282 Pac. 813, 815.

to frame any adequate comprehensive definition of the term. Nevertheless, in considering what constitutes a security under the Act, the courts have recognized certain criteria.

Under the first test, generally speaking, the investor must put up money, or its equivalent, for a share or stake in an enterprise or venture with the expectation of profit. Although, as heretofore discussed, there are various instances of issues of corporate securities requiring a permit which do not strictly involve "sales" in the usual sense,⁴¹ nevertheless most instances of issues of non-corporate "securities" involve a sale. The investor gives money into the hands of another with the expectation of profit—he buys something. Thus it would appear indisputable that the interest or right of a donee-beneficiary in a trust which the beneficiary receives as a pure gratuity, and for which he gives neither money nor its equivalent in property or services, is clearly not a "security" requiring a permit.

The second test applied by the courts in determining what constitutes a "security" relates to the degree of control the investor has over the property or business venture in which he has acquired an interest or stake. This apparently is the chief criterion applied by the courts. If the investor is to participate actively in the management or conduct of the enterprise, he is not purchasing or acquiring a "security".⁴² On the other hand, if the investor is to assume a merely passive role—other than supplying a portion of the funds—with the right or expectation of sharing in the profits, and the enterprise is to be conducted and managed by the issuer, it is generally held that the sale of a "security" is involved. This test is somewhat fully expounded by the California supreme court in the leading case of *Domestic and Foreign Pet. Co. v. Long*.⁴³

The element of control or management by the seller is empha-

⁴¹ *E.g.*, true share dividends, stock split-ups, etc.

⁴² *Austin v. Hallmark Oil Co.* (1943) 21 Cal. (2d) 718, 134 P. (2d) 777; *People v. Steel* (1934) 2 Cal. App. (2d) 370, 36 P. (2d) 40.

⁴³ (1935) 4 Cal. (2d) 547, 51 P. (2d) 73, wherein the court stated (p.555):

"Instruments such as those in the *Craven* case and the instant case are not issued to persons who expect to reap a profit from their own services and efforts exerted in the management and operation of oil-bearing property, but to those in the category of investors, who, for a consideration paid, stipulate for a right to share in the profits or proceeds of a business enterprise or venture to be conducted by others. The defendants herein have less voice in the control of the enterprise than stockholders in a corporation, who may vote at stockholders' meetings. . . . In decisions of this state . . . the courts have looked through form to substance and found that in fact the transaction contemplated the conduct of a business enterprise by others than the purchasers, in the profits or proceeds of which the purchasers were to share."

sized in a number of the decisions. Even transactions in which rabbits were sold but the buyers contracted to leave the animals in the vendor's possession and under his management, in consideration of his right to share in the increase, have been held to be sales of "securities".⁴⁴ Also the sale of grant deeds to land to be managed by the seller constitutes the sale of "securities".⁴⁵ The courts have even held that a sale of interests in an oil and gas lease amounts to a sale of "securities" although the assignor purports to divest himself completely of all ownership and to give to the assignee *all* of the former's interest in described portions of land, if, in fact, the assignor is to conduct the operations, and the assignees are merely to share in the products of his efforts.⁴⁶

In determining what constitutes a "security" there is a third factor which has a bearing, chiefly on the question of good faith and lack of intent to evade the Act, namely, the extent to which the "interests" are offered to the public. It is true that the Act has always required a permit for the issuance of a corporate security even though a single private transaction is involved and there is no public offering.⁴⁷ Moreover, since the 1929 Amendment to the Act, an "interest" sold by an individual-issuer may constitute a security even though sold at private sale where there is no public offering.⁴⁸ Prior to the 1945 amendment relating to partnership interests, which is discussed *infra*, the Act at no time since 1929 expressly made an offering to the public a test except for one single purpose, namely, the exemption from the Act of promissory notes not offered to the public.⁴⁹ Nevertheless, since the Act is designed primarily to protect the public from exploitation in the field of security sales, it is believed that a total absence of a public offering has an important evidentiary bearing in determining what constitutes a "security" in certain borderline cases, particularly in the case of partnership interests.

⁴⁴ *Gracchi v. Friedlander* (1928) 93 Cal. App. 770, 270 Pac. 235.

⁴⁵ *People v. Yant* (1938) 26 Cal. App. (2d) 725, 80 P. (2d) 506; *People v. McCalla*, *supra* note 36.

⁴⁶ *People v. Rubens* (1936) 11 Cal. App. (2d) 576, 54 P. (2d) 98; *El Claro Oil Co. v. Daugherty* (1936) 11 Cal. App. (2d) 274, 53 P. (2d) 1028.

⁴⁷ *Domestic & Pet. Co. v. Long* (1935) 4 Cal. (2d) 547, 51 P. (2d) 73, wherein the court stated: "It may be ascertained from records of the Commissioner of Corporations that a large percentage of the applications examined are for closed permits, that is, for permits to issue securities in private transactions."

⁴⁸ *Cecil B. deMille Productions v. Woolery* (1932) 61 F. (2d) 45 (C.C.A. 9th, 1932).

⁴⁹ Act §2(b)11.

As a general rule, the sale of "securities" that is condemned by the courts involves an attempt by an issuer to raise funds for a business venture or enterprise; an indiscriminate offering to the public at large where the persons solicited are selected at random; a passive position on the part of the investor; and the conduct of the enterprise by the issuer with other people's money.

The wide variety of "interests" that have been held to be "securities" regardless of the character of the issuer, whether a corporation, business trust, trustee, individual, or others, is too well known to require elaboration.⁵⁰ However, the problem of individual-issuers calls for further special treatment.

Many trust interests are clearly "securities" requiring a permit. This is true even though they do not provide for the payment of money, e.g., certificates of deposit of securities issued by a committee or trustee in contemplation of a reorganization.

There are, also, two special types of interests, namely, partnership interests and pension plan interests, which have recently been the subject of statewide debate and controversy as to whether they constitute "securities" within the meaning of the Act. The 1945 Legislature enacted two separate pieces of legislation dealing with these problems. Before appraising this legislation it is believed that a discussion of its setting would be helpful to a general understanding of the basic theory of the Act.

The Act from its inception has defined an issuer ("company") to include (i) "partnerships of every kind," and (ii) trustees of "all voluntary trusts . . . expressly created by or declared in an instrument in writing the purpose of which is . . . to secure the payment or repayment of money, but shall not be deemed to include a trust created or declared under or by virtue of a will, judicial writ, order, decree, or judgment."

Despite the generality of this language, it should be construed, as was said in a leading blue-sky case, "with common sense and sound reasoning" so as to effectuate the purposes of the Act.⁵¹

⁵⁰ *E.g.*, beneficial interests in a common law or business trust (*In re Girard* (1921) 186 Cal. 718, 200 Pac. 593), or in an unincorporated association (*Boss v. Silent Drama Syndicate* (1927) 82 Cal. App. 109, 255 Pac. 225; *Barrett v. Gore* (1928) 88 Cal. App. 372, 263 Pac. 564); "percents" in oil proceeds (*Domestic & Foreign Pet. Co. v. Long*, *supra* note 47); units in an oil syndicate or in an oil trust (*People v. McCalla*, *supra* note 36; *Barrett v. Gore*, *supra*); beneficial interests in land (*Mary Pickford Co. v. Bayly Bros., Inc.* (1939) 12 Cal. (2d) 501, 86 P. (2d) 102).

⁵¹ *Kneeland v. Emerton* (1932) 280 Mass. 371, 183 N.E. 155.

There is a familiar rule of statutory construction which excludes from the coverage of a statute things or situations which, though within the letter, do not fall within the spirit, of the statute and are therefore excluded as beyond the legislative intent.⁵² The manifest reason and obvious purpose of the legislation should not be sacrificed to a literal interpretation of the words.⁵³

Partnership Interests.

Despite the literal wording of the Act, there has been a consistent administrative interpretation continuously since its enactment—at least until very recently—to the effect that *bona fide* general and limited partnership memberships do not constitute “securities” requiring a permit. Moreover, the California Bar generally has proceeded with the assurance that no permit is required for memberships either in the case of a *bona fide* general partnership or in the case of a *bona fide* limited partnership. So far as known, no law partnership, public accountancy partnership, or stock brokerage partnership has ever applied for a permit to issue its memberships.⁵⁴

However, owing to the publication some months ago in the Los Angeles Bar Association Journal of an article by Mr. Herbert A. Smith, Executive Deputy Commissioner of Corporations, on the subject of “Limited Partnership Interests as Securities Under the Corporate Securities Act”, some doubt was raised among some of the members of the Bar as to whether a permit is required for partnership interests, and particularly limited partnership interests to which Mr. Smith’s comments are confined. That article, of course, does not purport to be an official ruling of the Division of Corporations. So far as known, the Division has not changed its consistent continuous interpretation that *bona fide* partnership interests do not constitute “securities” requiring a permit. Moreover, Mr. Smith himself does not assert any contrary opinion. He merely discusses certain decisions

⁵² *Carolene Products Co. v. United States* (1944) 323 U.S. 18, citing *Church of the Holy Trinity v. United States* (1891) 143 U.S. 457, 12 Sup. Ct. 511, and *United States v. Aetna Explosives Co.* (1920) 256 U.S. 402.

⁵³ 2 SUTHERLAND, STATUTORY CONSTRUCTION (3d ed.) §§4701, 4706.

⁵⁴ It is well known generally and also to the Corporation Commissioner, by reason of his periodic issuance of brokers’ certificates, that certain brokerage firms doing business in California have many members. The number of members alone, of course, is not the test. One well known New York Stock Exchange member firm has more than fifty general partners. It is believed that the Commissioner has never asserted that any such firm which he knows from records in his Division to be a *bona fide* partnership, should apply for a permit to “issue” its memberships.

of the district courts of appeal⁵⁵ which have held certain so-called partnership interests to constitute "securities" within the meaning of the Act.

It is often misleading to press too far analogies from the field of federal income tax law, chiefly because the Internal Revenue Code provides its own definition of "corporations" and "partnerships", and it is elemental that status under local law is of no importance in this connection.⁵⁶ Nevertheless, in considering whether partnership interests constitute "securities", certain illumination can be gained from the decisions which have considered the differences between partnerships and corporations for taxing purposes. The Internal Revenue Code definition of a "corporation" includes an "association". The cases defining an "association" for purposes of federal taxation have enumerated five characteristics or criteria distinguishing an "association" from a "partnership".⁵⁷ These five characteristics are (i) unity of title, that is, title to property held by the entity; (ii) unity of management, or centralization of control; (iii) continuity of existence uninterrupted by the deaths of the beneficial partners; (iv) free transferability of beneficial interests without affecting the continuity of existence; and (v) limitation of personal liability of the participants. While the foregoing five characteristics are the constituent features of an association, other circumstances have been given weight in determining whether a business enterprise is an association or a partnership for tax purposes, e.g., whether formal certificates of partnership are filed or recorded, and the lack of other formal proceedings, such as minutes and by-laws. An enterprise may be an association although it does not have all of the five constituent features. Generally speaking, the courts balance the corporate and partnership charac-

⁵⁵ *People v. Simonsen* (1923) 64 Cal. App. 97, 220 Pac. 442; *Barrett v. Gore* (1928) 88 Cal. App. 372, 263 Pac. 564; *People v. Oliver* (1929) 102 Cal. App. 29, 282 Pac. 813; *People v. Claggett* (1933) 130 Cal. App. 141, 19 P. (2d) 805; *People v. Dysart* (1940) 39 Cal. App. (2d) 287, 102 P. (2d) 1091; *People v. Dutton* (1940) 41 Cal. App. (2d) 866, 107 P. (2d) 937, and *Churchill v. Peters* (1943) 57 Cal. App. (2d) 521, 134 P. (2d) 841. The California supreme court has never squarely considered this problem.

⁵⁶ *Burk-Waggoner Oil Assoc. v. Hopkins* (1925) 269 U.S. 110, in which Mr. Justice Brandeis said, "It is true that Congress cannot convert into a corporation an organization which by the law of its State is deemed to be a partnership. But nothing in the Constitution precludes Congress from taxing as a corporation an association, which, although not incorporated, transacts its business as though incorporated." *Cf.* also, Regulation 111, §29.3797-1-2-4.

⁵⁷ *Morrissey v. Commissioner* (1935) 296 U.S. 344; *Commissioner v. Rector & Davidson* (C.C.A. 5th, 1940) 111 F. (2d) 332; *Del Mar Addition v. Commissioner* (1940) 113 F. (2d) 410.

teristics and the solution is obtained by weighing and not merely by counting.

For general purposes, a true partnership has certain clearly defined characteristics. The Uniform Partnership Act, which has been adopted in many states, including California, does not make the partnership an independent juristic entity, but continues the pluralistic notion of the firm evolved by the English Chancellors.⁵⁸ A true partnership clearly does not have unity of title nor continuity of existence. Moreover, except in certain cases of limited partnerships, there is no unity of management or centralization of control.

It is believed that one of the chief criteria for determining whether an interest in a partnership is a "security" under the Act is the element of selection of the partners. In all general partnerships, and also in *bona fide* limited partnerships, there is the right of *delectus personarum*, the right to determine membership. No partner is admitted without unanimous approval of every other partner. A true partnership is a relation of personal confidence and is a select closed group. Its memberships are never indiscriminately offered at random to the public at large. Even in the case of a limited partnership the certificate⁵⁹ must expressly state the right, if given, of a limited partner to substitute an assignee as contributor in his place, and the terms and conditions of the substitution, and the right, if given, of the partners to admit additional partners. In either such case the certificate must be amended and signed and sworn to by all partners, including any member to be substituted or added, and when a limited partner is to be substituted, also by the assigning limited partner.⁶⁰

Limited partnerships are creatures of statute requiring formal statutory compliance. They do not readily lend themselves to bold and dishonest schemes whereby capital is raised to carry out a venture by indiscriminate solicitation of the public at large. As long as the requirement of unanimous agreement on the body of membership is preserved it would appear clear that the partnership is not an issuer of a "security". Moreover, even in the case where a limited partner assigns his interest to another, if there is unanimous agreement to the substitution and the formal certificate requirements are complied with, there is no sale of a "security". Wherever the elements of unanimous selection of the members and lack of free assignability

⁵⁸ *Helvering v. Smith* (C.C.A. 2d, 1937) 90 F. (2d) 590.

⁵⁹ CAL. CIVIL CODE §2479.

⁶⁰ *Ibid.*, §§2500, 2501.

of the interests exist, there is a true partnership, whether general or limited, and no permit should be required.

In every one of the above mentioned decisions of the district courts of appeal there would appear to be special circumstances which negative any idea of a *bona fide* partnership.

In the *Simonsen* case, which was the first of the series, the court stated:

"The public requires protection against the *indiscriminate sale of partnership securities* in somewhat the same measure in which it requires protection against a similar sale of corporate securities."

While the facts in that case are not clearly stated in the opinion, the reasonable inference is that there was a solicitation of the public at large and a sale of "interests" at random.

In each of the other cases there was either gross fraud or the court stressed the fact that the parties "claimed" to be partners, or that the enterprise was an "alleged" or "purported" partnership. In several of the cases there were numerous counts of violation of the Act and also numerous counts of grand theft. Several of the cases were decided prior to the time California adopted the Uniform Limited Partnership Act in 1929. In the later cases, and particularly the last one, namely, *Churchill v. Peters*, the court stressed that the enterprise was only a purported partnership. In the *Churchill* case there was an actual finding that no certificate of limited partnership was filed as required by Civil Code Section 2478, and that no limited partnership was organized. There were also numerous findings of fraud and the court held that "under the circumstances" the certificates of interest which had been sold to many people were "securities".

The 1945 Legislature added a new paragraph 12⁶¹ to Subdivision (b), Sec. 2 of the Act, reading as follows:

"(b)". Securities exempted from act. . . .

"12. Any partnership interest in a general partnership, or in a limited partnership where certificates are executed, filed and recorded as provided by Section 2478 or Section 2501 of the Civil Code of the State of California, except partnership interests when offered to the public."

It is to be noted that the wording of this amendment, and its particular placement under Subdivision (b), gives recognition to

⁶¹ Cal. Stats. 1945, c. 399.

partnership interests as "securities". They are merely exempted under certain conditions, principally if they are not offered to the public. Moreover, the amendment is not aptly worded so as to make it clear that it is only declaratory in its effect, and not a change in legislative intent. Despite this, it is submitted for the reasons stated above, that neither a *bona fide* general partnership or limited partnership formed prior to September 15, 1945 (the effective date of the amendment) required a permit for the "issue" of its memberships.

It is to be stressed, however, that in this field, as elsewhere in construing the Act, the courts disregard form and look to substance. There is no sham partnership, either general or limited, which masquerades as such to exploit investors, or which is in reality availed of merely to evade the Act, no matter how perfect in "paper form", that could not be subjected to the corrective sanctions of the Act.

*Pension Plan Interests.*⁶²

Many pension plans involve no trust of any kind. As to such plans it is not believed that anyone seriously contends that a permit is required under the Act. A simple profit sharing plan whereby the employer agrees to pay specified employees, as additional contingent compensation, a percentage of the net profits of the business at periodic intervals, clearly does not involve the issuance of a "security".

Until comparatively recently when the Attorney General rendered certain opinions hereinafter discussed, the Bar generally—and it is believed the Division of Corporations also—proceeded on the assumption that even pension plans involving trusts did not require a permit in the absence of special circumstances. Despite the literal wording of the language of the Act which includes "trusts" within the definition of the term issuer ("company"), it would appear too absurd to merit serious discussion to contend that every *inter vivos* trust "to secure the payment or repayment of money" involves the issuance of a "security". Such a literal construction would require a permit for every living family trust—a result the legislature could never reasonably have intended.

Generally speaking, a trust must have two characteristics to constitute it an issuer under the Act. First, it must be a venture or business or enterprise created for the purpose of producing profit. Secondly,

⁶²The term "pension plan interests" is used herein somewhat loosely to mean any employees' retirement system, pension plan or profit sharing plan. It purposely does not include any employees' stock bonus plan, since it would appear indisputable that a stock bonus plan which involves the issue of securities by an employer-issuer to employees would require a permit for such securities.

the beneficiaries must be contributors either of money or its equivalent in property.⁶³ Any trust under which all the beneficiaries are pure donee-beneficiaries would appear clearly not to be an issuer under the Act.

The recent opinions of the Attorney General above referred to hold that every pension plan involving a trust fund where the trustee has discretionary power to invest the funds other than for the purchase of insurance or annuities, constitutes an "issue" of securities for which a permit must be obtained—even though the plan be a non-contributory plan under which the employees pay no money. The opinions state, in effect, that in the case of non-contributory pension plans the employee nevertheless "purchases" his interest in the plan by the rendition of services. In marked contrast to these opinions, counsel for the Securities and Exchange Commission has rendered an opinion that neither non-contributory pension plans nor compulsory pension plans involve an "offer" or "sale" of a security.⁶⁴

It is possible that in certain pension plans there might be present both a "security" and a "sale" which would require a permit. Thus, if there is a trustee with discretionary power to invest the funds other than for the purchase of insurance or annuities, and the employee makes volitional contributions to the fund, and acquires a withdrawable and assignable interest, it would appear that the sale of a security would be involved and a permit required. However, aside from plans involving such special circumstances and stock bonus plans involving securities of the employer itself, it is submitted that the Attorney General's opinions are unsound.

Moreover, as a practical matter, it would lead to absurd results—and no true protection—if pension plans generally were held to be subject to the permit provisions of the Act. Pension plans are not ventures to produce profit, and it requires a great straining of definition to hold that employee-beneficiaries of a pension plan are pur-

⁶³ It is true that certain trust interests, by express enumeration in the statutory definition, constitute "securities" even though they do not involve any contribution or payment of money and are not designed to produce profit. Thus the Act expressly includes "any certificate of deposit for a security" in the definition of a "security." But even in such cases there is an exchange which is the equivalent of a sale. The beneficiary clearly deposits or gives value.

⁶⁴ C. C. H. FEDERAL SECURITIES LAW SERVICE 1941-44 DECISIONS, ¶75, 195. It is also to be noted that §3(a)(8) of the Securities Act of 1933 expressly exempts insurance and annuity contracts from registration, and the Investment Company Act of 1940 exempts, in §3(c)(13) thereof, "any employees' stock bonus, pension, or profit-sharing trust which meets the conditions of §165 of the Internal Revenue Code."

chasers of a "security". Furthermore, it would appear clearly beyond the legislative intent to place pension plans under the permit provisions of the Act. If they are to be subjected to state regulation at all, it is submitted that they call for a type of control that is wholly lacking in the Act.

The issuance of a permit under the Act is merely a sort of matriculation examination designed to ensure fair play to the investors at the time of their entrance as participants in a business venture or enterprise. The permit of the Corporation Commissioner can do no more than give the investors—at the start—a fair break or even run for their money. Generally speaking, once the permit is issued the function of the Division of Corporations ceases. Unlike regulatory bodies which exercise continuing visitatorial power over other businesses, such as banks, insurance companies and public utilities, the jurisdiction of the Commissioner of Corporations under the permit provisions of the Act is not a continuing one. Even though conditions subsequent are inserted in a permit, such conditions would be wholly inadequate to provide a continuing policing power by the Commissioner of Corporations over pension plans. If pension plans are to be regulated at all, they do not belong under the Act, but should be regulated by some effective method which ensures a continuing policing of the fund to safeguard its honest application and accounting. Subjecting such plans to the requirement of obtaining a permit would appear to be wholly inefficacious. In apparent recognition of this fact, the 1945 Legislature adopted "The Retirement Systems Act",⁶⁵ which subjects pension plans to controls entirely independent of the Act, and confers on the Commissioner of Corporations, under a separate statute, a continuing policing power over the application and accounting of the funds. It is to be noted that beneficial interests, as defined by The Retirement Systems Act, are exempt from the provisions of the Corporate Securities Act. Moreover, The Retirement Systems Act, in order to avoid burdensome and unnecessary duplication, expressly exempts all pension plans which are subject to the scrutiny of other regulatory bodies, such as the Superintendent of Banks, Insurance Commissioner, Railroad Commission, Federal Communications Commission, and other like regulatory agencies.

⁶⁵ Cal. Stats. 1945, c. 1035.