

Regulation and Civil Liability Under the California Corporate Securities Act:II

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This is the second of a series of articles being published under the above title.

WHAT CONSTITUTES AN "ISSUE" OF A SECURITY?

The Act does not define the word "issuer", and indeed does not even use it. It is significant that in every federal or state securities act which does define the term "issuer", legislative ingenuity has failed to devise a definition of the primary meaning—every such statute defines it in terms of the verb "issue".

Despite the wealth of decisional law arising under the Act, there is surprisingly little discussion of the meaning of the word "issue" in the cases. It has been suggested that the absence of conflict over this term is explained by the fact that, at least as to negotiable instruments which constitute the bulk of all securities, the same meaning is given to the term as is adopted by the Uniform Negotiable Instruments Act,⁶⁶ under which "issue" means "the first delivery of the instrument, complete in form, to a person who takes it as a holder." More accurately, the explanation would appear to lie in the fact that the term is accepted in its ordinary meaning, that is, an original coming into being.

The cases arising under general law involving the question as to when bonds are "issued and outstanding" are of material aid in ascertaining the correct meaning of the term "issue" under the Act. Bonds which have been fully executed by the obligor corporation and formally authenticated by the indenture trustee and delivered to the trustee as custodian for, and subject to the order of, the obligor, or retained by the obligor unencumbered in its treasury, are not "issued and outstanding". In a leading New York case involving the foregoing set of facts, it was held that "The bonds were not 'issued and outstanding' while retained by the mortgagor or its depository. They

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⁶⁶Note (1937) 10 So. CALIF. L. REV., 483, 486.

did not get that quality until someone received and held them as enforceable obligations.”⁶⁷

The California courts have also held that bonds are not deemed to be issued until they are actually sold or delivered for a consideration.⁶⁸ Likewise, shares “which have never passed to the ownership of stockholders” are not issued.⁶⁹ Mere offers, negotiations or executory contracts do not constitute “issues”.

That other mere preliminary acts do not constitute an issuance is held in the case of *Blythe v. Doheny*,⁷⁰ a decision of the ninth circuit court of appeals involving the California Corporate Securities Act, which contains one of the most extensive discussions of what constitutes the “issuance” of a security within the meaning of the Act and which has been cited with approval by the supreme court of California.⁷¹ In that case the directors of a Delaware corporation, at a meeting in California, had authorized generally the issuance of corporate shares. Subsequently, some of the shares so authorized were sold to plaintiff in St. Louis. At the time the shares were purchased by plaintiff, the issuing corporation had not complied with any of the provisions of the Corporate Securities Act of California. Plaintiff sued for recovery of the purchase price paid by him on the grounds that the shares were void by reason of failure to secure a permit under the Act. The court below held that none of the shares so sold were issued in California and that no permit was required. The circuit court of appeals sustained this holding on the ground that the mere authorization of the directors at a meeting in California did not amount to an issue in California. The court stated that a certificate is not necessary to effectuate an issue of stock but it is, however, necessary that there be an issuance to some specific person. A mere blanket authorization passed by the board of directors to the effect that there shall be an issuance of stock, without more, does not meet either the legal or the popular definition of “issuance”.

The term “issue” in the Act would therefore appear to mean the

⁶⁷ *Bankers Trust Co. v. Denver Tramway Co.* (1922) 233 N. Y. 604, 135 N. E. 936, 937. See also *Wyman v. Hageman* (1925) 318 Ill. 64, 148 N. E. 852.

⁶⁸ “It cannot be said that the bonds have been issued until they have been sold and placed in the hands of third parties so as to create an obligation against the district.” *Moreing v. Shields* (1915) 28 Cal. App. 513, 517, 152 Pac. 964, 966.

⁶⁹ *Market Street Railway Co. v. Hellman* (1895) 109 Cal. 571, 42 Pac. 225.

⁷⁰ (1934) 73 F. (2d) 799.

⁷¹ *Domestic & Foreign Pet. Co. v. Long* (1935) 4 Cal. (2d) 547, 51 P. (2d) 73.

final act⁷² of an issuer (including, of course, its agents or persons acting on its behalf) by which its securities are first and fully vested in third parties who give a valuable consideration which accrues wholly or in part to the benefit of the issuer. In short, the term "issue" when applied to securities, is construed almost unanimously by the courts and text writers to mean, in essence, an original coming into existence.

Reissue of certificates not an issue of shares.

Under the Act and decisions it is axiomatic that a mere bona fide transfer or resale, by a person not the issuer thereof, of a security already validly issued, is not an "issue" within the meaning of the Act and in no such case is a permit required. This would be true whether such securities had been theretofore validly issued in California pursuant to a permit of the Commissioner of Corporations or whether the securities were validly issued outside the state without any permit of the Commissioner of Corporations.

Moreover, the issuer, whether a domestic or foreign corporation, does not require a permit to transfer in this state its securities which have theretofore been originally validly issued, since the issue of new certificates in connection with a simple transfer does not constitute an issue of securities within the meaning of the Act. Thus, in the case of *Rhoades v. Townsend*,⁷³ a Maine corporation had validly issued its shares in Maine. The shares were subsequently transferred to defendants and new certificates were issued to them at the office of the corporation in California. The contention was made that the stock was void because issued in California without a permit. In holding this contention to be without merit, the court stated that "The act of the corporation in California was simply that of reissuing new certificates for those previously issued by the corporation . . . the stock was lawfully in the hands of those who transferred to appellants. Under such circumstances no permit was required for the reissue of the stock in California."⁷⁴

Such transfers merely involve the "issue" of new certificates evidencing the shares; they do not involve any issue of the shares themselves, which of necessity are already outstanding. Thus, it is per-

⁷² See particularly *Robbins v. Pacific Eastern Corp.* (1937) 8 Cal. (2d) 241, 65 P. (2d) 42; *Los Angeles Fisheries Co. v. Crook* (C. C. A. 9th, 1931) 47 F. (2d) 1031; *In re Motor Products Mfg. Corp.* (C. C. A. 9th, 1936) 85 F. (2d) 313.

⁷³ (1934) 139 Cal. App. 121, 33 P. (2d) 860.

⁷⁴ *Ibid.* at 129, 33 P. (2d) at 863.

fectly proper for a foreign corporation which has previously issued its securities outside this state to have transfer agents in different cities, including a California city. In no such case would a permit be required. The situation is of course different if the transaction is not a simple transfer, but involves an offering in this state of new or modified securities by a foreign issuer.

Written evidence as requisite of issuance.

In the usual and ordinary course of business it is considered that a certificate or some form of writing is necessary to evidence a security. As stated by the California supreme court, "to business men, certificates and the shares represented thereby are inseparable."⁷⁵ However, while ordinarily title passes upon delivery of the certificate, a physical delivery of a certificate is not necessary to effectuate an issue.⁷⁶

Nevertheless, it should be noted that there is a marked difference, particularly with respect to shares of capital stock, between an original issue and a transfer or resale. In the latter case passage of title ordinarily requires the delivery of a duly endorsed certificate or an equivalent writing. Indeed, the buyer is not fully protected until such transfer is registered on the books of the corporation. However, in the case of an original issue of stock, a physical delivery of a certificate is not necessary. The issue of stock is the act which creates and completes the corporation-stockholder status—the step when "shares pass to the ownership of stockholders". Since the certificate is merely the evidence of the shares and not the shares themselves, the shares may be issued without any certificate or other writing. Thus, one may become a shareholder upon the execution of a subscription agreement or upon the payment of the subscription price. Moreover, it is well established that the actual owner of shares may exercise his rights without a certificate therefor.⁷⁷

On the other hand, generally speaking, the issue of a bond, note, beneficial interest, or any other security excepting only a share of stock, would appear to require actual delivery of a certificate or some form of writing. This is particularly true with respect to bonds

⁷⁵ *Robbins v. Pacific Eastern Corp.*, *supra* note 72, at 275, 65 P. (2d) at 59.

⁷⁶ "... certificates are only the evidence of ownership of shares of stock, and . . . shares may be issued, held, and dealt with under some circumstances without certificates." *Ibid.*

⁷⁷ *Jean v. Jean* (1929) 207 Cal. 115, 277 Pac. 313; *Kauffman v. Meyberg* (1943) 59 Cal. App. (2d) 730, 140 P. (2d) 210.

and other evidences of debt. The indebtedness in all such cases is integrated in the paper itself.⁷⁸

Finally, in this connection, it is well established that the form of the instrument is not controlling as to whether the transaction constitutes an "issue" or merely an assignment or transfer. Thus, various California cases have held that the delivery of an instrument, which on its face is merely a "transfer and assignment",⁷⁹ or a deed,⁸⁰ or a loan agreement,⁸¹ nevertheless constitutes an *issue* of a security.

Sham or evasive "issues".

There is a long line of cases in California, principally of a criminal nature, several of which are cited under this caption, which hold that where securities are purportedly issued outside the state to a promoter or fiscal agent, with the express intention of reselling such securities in California, a permit is required for such alleged "resale" in California if all or part of the proceeds of sale inure to the benefit of the issuer. All such cases involve active fraud or sham, and a clear intent to evade the Act. While the means employed in such cases vary somewhat, the basic underlying scheme is essentially the same. There is generally a familiar pattern. A new foreign corporation is literally hatched overnight, which purports to issue its securities outside the state to a promoter either for services, or for property of doubtful value, or for a promissory note, or under a contract. The promoter then, posing as an *owner* of already issued and outstanding securities, peddles them to the public in California for the benefit of the issuer. The scheme is reminiscent of the old device frequently employed before the days of no-par stock where promoters turned stock allegedly issued to them over to a trustee to be held and disposed of for the benefit of the corporation, as a method of selling stock to the public at less than its par value. Such trusts were obviously naked trusts and the corporation was, in fact, the owner of everything except the record title.

The California courts, in holding that the Act has been violated in such evasion cases, rest their decisions on various grounds. Some of the cases hold that the promoter who purports to purchase the

⁷⁸ "Bonds and negotiable instruments are more than merely evidences of debt. The debt is inseparable from the paper which declares and constitutes it . . ." Blackstone v. Miller (1903) 188 U. S. 189, 206.

⁷⁹ Mary Pickford Co. v. Bayly Brothers, Inc. (1939) 12 Cal. (2d) 501, 86 P. (2d) 102.

⁸⁰ Domestic & Foreign Pet. Co. v. Long, *supra* note 71.

⁸¹ People v. Sidwell (1945) 27 A. C. 122, 162 P. (2d) 913.

securities outside the state is not a bona fide owner of the securities;⁸² or that he is the mere *alter ego* or instrumentality of the corporation-issuer.⁸³ Other cases speak of the promoter, pretending to be the owner of the securities, as an *issuer* himself.⁸⁴ Or the evasive transaction is condemned as a mere "wash sale".⁸⁵

It is believed that the true rationale of all such cases involving sham or evasion is that the actual *issue* occurs only when the securities are first sold in California for the benefit of the issuer by the unscrupulous promoter or fiscal agent masquerading as an owner, and the preliminary pretended issue or sale to such promoter or fiscal agent is a mere sham or fictitious issue. The first step in such cases, when the physical certificates are issued or delivered outside the state to the promoter, is closely analogous to the cases dealing with executed and authenticated bonds delivered to a trustee or retained by the obligor but not yet sold or placed in the hands of third parties for a lawful consideration. Such act does not pass valid title to the securities to the promoter and does not constitute a legal "issue", which occurs for the first time when the securities are "resold" in California. Moreover, in such cases of fictitious issues there is always actual fraud, a deliberate attempt to mask the transaction and a clear intent to evade the Act.

In short, our California courts make the same realistic approach under the Act as the federal courts do in cases involving the revenue. In the tax field, form is disregarded where it is a sham or unreal. The courts do not permit the true nature of a transaction to be disguised by mere formalism. "In such situations the form is a bald and mischievous fiction."⁸⁶

⁸² *People v. Eiseman* (1926) 78 Cal. App. 223, 248 Pac. 716; *People v. Smith* (1931) 111 Cal. App. 177, 295 Pac. 105.

⁸³ *People v. Ratliff* (1933) 131 Cal. App. 763, 22 P. (2d) 245.

⁸⁴ *People v. Murphy* (1936) 17 Cal. App. (2d) 575, 62 P. (2d) 592.

⁸⁵ *People v. Doble* (1928) 203 Cal. 510, 265 Pac. 184, wherein agents of a corporation which had obtained a permit in California to sell its securities took subscriptions for such securities in excess of permit limitations. In an attempt to cover such excess subscriptions the agents of the corporation, including its fiscal agent, arranged a pretended sale and delivery of securities to the fiscal agent outside the state for the purpose of supplying him with securities to meet the excess subscriptions. The court condemned this transaction as a mere "wash sale", holding that in reality it was a sale by the corporation, through the conspirators, of the corporation's own stock to the public in California.

⁸⁶ *Moline Properties, Inc. v. Comm'r* (1943) 319 U.S. 436; *cf. Gregory v. Helvering* (1935) 293 U.S. 465; *Griffiths v. Comm'r* (1939) 308 U.S. 355; *Higgins v. Smith* (1940) 308 U.S. 473; *Commissioner v. Court Holding Co.* (1945) 324 U.S. 331; *National Inv. Corp. v. Hoey* (1944) 144 F. (2d) 466.

Likewise, mere formalities designed to evade the Act are ineffectual. "Temporary compliance with statutory literalness is futile." On the other hand, the spurious schemes of promoters who merely go through the form of issuing securities outside the state for the purpose of evading the Act, should not be confused with bona fide securities transactions by established, reputable foreign corporations—a subject which will be discussed under a subsequent caption.

Reorganizations; modification of outstanding securities as constituting a new issue.

The Securities Act of 1933,⁸⁷ and a number of the state securities acts,⁸⁸ expressly exempt an exchange of securities by an issuer exclusively with its existing security holders where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange. The commonly stated purpose of such exemption is that no regulation is required where all "high pressure salesmanship" and promotional activity is absent.

Moreover, no registration is required under the Securities Act of 1933 in connection with statutory mergers or consolidations and certain other types of "reorganizations" in which the Securities and Exchange Commission deems no "sale" to be involved,⁸⁹ although none of the exemptions granted either by section 3(a)(9) or 3(a)(10) of that act is available.

The California Act is much more stringent. Except for the exemption, first granted by the 1945 amendment to the Act,⁹⁰ of securities issued under a plan confirmed by a court under the Federal Bankruptcy Act, it contains no exemption in connection with recapitalizations, reorganizations or other exchanges of securities, regardless of whether or not commissions are paid for solicitations.

Under California law there are three principal types of reorganizations or recapitalizations involving exchanges of outstanding securities. Each of them unquestionably requires a permit.

The first category embraces voluntary recapitalizations. Thus,

⁸⁷ Section 3(a)(9), 48 STAT. (1933) 74, *ibid.* (1934) 906, 15 U. S. C. (1940) §§ 77a, 77c(a)(9). See also exemption granted by section 3(a)(10) of that Act, *ibid.*

⁸⁸ *E.g.*, Illinois, Indiana, Massachusetts, Michigan, Minnesota, Ohio and Pennsylvania. See Corporation Manual (U. S. Corporation Company 1946 ed.) "Blue Sky Laws."

⁸⁹ See Note following Rule 5(3) of the Rules as to the Use of Form E-1 (For Securities in Reorganization). Under such Rules the term "reorganization" is given a broad meaning.

⁹⁰ Cal. Stats. 1945, p. 856, adding new paragraph 13 to subdivision (b) of section 2 of the Act.

under the general corporation laws of California and several other states⁹¹ if a corporation has an outstanding issue of preferred shares having a substantial arrearage of accrued and unpaid dividends, it is permissible by vote of the requisite percentage of shareholders to authorize a new class of preferred shares senior in all respects to all classes of outstanding shares. Such new prior preferred shares (often with some common shares or other "boot" included) are then offered in exchange to the holders of the old preferred shares for their entire bundle of rights, including the right to receive accrued dividends. The "package" so offered must afford full compensation for the old shares. It is entirely optional on the part of the existing preferred shareholders to accept such offer, but if they do not they are relegated to a position junior to that of the preferred shareholders who do accept. Moreover, such plans are usually made sufficiently attractive to induce acceptance by the preferred shareholders.

A further illustration of a voluntary recapitalization is furnished by a corporation which has an issue of redeemable preferred stock outstanding and which creates a new class of preferred stock, carrying a lower dividend rate, which is offered in exchange to its existing preferred shareholders, at their election. The old preferred shares of those shareholders who do not accept the exchange offer are then redeemed.

The second class of recapitalizations consists of compulsory statutory recapitalizations. Under California law numerous changes in outstanding shares may be effected by the requisite vote of shareholders,⁹² which become binding on all shareholders, including dissenters, without any right of appraisal. Thus, the dividend rate on outstanding shares may be reduced *in futuro* by an amendment of the articles voted by the requisite number of shareholders. Such amendment binds all shareholders, and there is no provision in California for compensation of dissenting minority shareholders in such case.

All voluntary and statutory recapitalizations require a permit, and the Commissioner of Corporations has a broad discretionary power in determining whether any given plan is "unfair, unjust or inequitable".⁹³ Regardless of the percentage of shareholders' approval, the Commissioner asserts the power to evaluate the fairness of any

⁹¹ CAL. CIV. CODE § 362a(3); DEL. CORP. LAW § 25; N. Y. STOCK CORP. LAW §§ 36, 38. But *cf.* NEV. GEN. CORP. LAW § 7(a) which is to the contrary.

⁹² *Cf.* CAL. CIV. CODE § 362a(3).

⁹³ *Cf.* Dohle Steam Motors Corp. v. Daugherty (1924) 195 Cal. 158, 232 Pac. 140.

plan involving a voluntary or statutory recapitalization. The rule under which a court of equity will not substitute its judgment for that of the directors or majority approving-shareholders in the absence of demonstrated bad faith or oppression, is apparently not applicable to the Commissioner's administrative determinations in such cases.

Mergers and consolidations, which comprise the third class of reorganizations, constitute the sole type of reorganization under which dissenters are accorded a right of appraisal under California law.⁹⁴

The legislature has deliberately extended the remedy by way of compensation only to cases of mergers and consolidations. Moreover, under the general corporation law of California, the dissenting shareholders' statutory appraisal proceeding is expressly made an exclusive remedy. As stated by the draftsman of the general corporation law,⁹⁵ this was done to protect majorities from the oppression of small unreasonable minorities, by providing cash compensation as a substitute for any other remedy. Furthermore, the general corporation law deliberately limits the dissenting shareholders in a merger or consolidation to the "fair market value of his shares", and not "fair cash value", or "intrinsic value", or "break-up value". Thus the clear design of the provision of the general corporation law governing mergers and consolidations is that the requisite majority may control the reorganization and obtain a speedy merger or consolidation, which may not be delayed or thwarted by any obstreperous minority, but dissenting shareholders are accorded a remedy which is designed to assure them the fair market value of their shares, as judicially determined.⁹⁶

On the other hand, despite the clear legislative declaration that the statutory appraisal proceeding constitutes the exclusive remedy of dissenting shareholders in the case of mergers and consolidations, the issuance of all securities pursuant to the plan must be authorized

⁹⁴ Various other states, including New York and Delaware, have provisions for compensation, not only for mergers and consolidations, but also for other types of reorganizations, and particularly statutory recapitalizations. The question whether the right of appraisal in California is too limited and whether it should also be extended to compulsory statutory recapitalizations, as has been done in several of the leading commercial states, is beyond the scope of this article. It is to be noted in passing that in California, upon the liquidation of a corporation, dissenting preferred shareholders are entitled to receive cash under certain conditions [CAL. CIV. CODE, § 401(c)], but a liquidation is not a reorganization in the sense that term is used herein.

⁹⁵ BALLANTINE, CALIFORNIA CORPORATION LAWS (2d ed. 1938) 267, *et. seq.*

⁹⁶ CAL. CIV. CODE § 369; BALLANTINE, *loc. cit. supra* note 95.

by the Commissioner of Corporations. The Division of Corporations asserts full power to pass on the fairness of the plan and the adequacy of the exchange ratios, regardless of the dissenters' right of appraisal and regardless of the percentage of the approving vote of shareholders. Moreover, the Division takes the position that in any merger or consolidation, if the holder of a single share opposes the plan, the Division has the power, in passing on the fairness of the plan, to evaluate the securities, and in doing so may require an appraisal of assets, although the securities of all constituent corporations are listed and actively traded in on a well-recognized national securities exchange. The Commissioner of Corporations, of course, has no power judicially to determine "the fair market value" of the shares of a dissenter, or to render a money judgment in favor of such dissenter. In essence the function of the Commissioner is negative. He is merely charged with the statutory duty of determining that the plan is "not unfair, unjust or inequitable".

In view of the plain and unambiguous provisions of the general corporation law, it is arguable that in merger and consolidation plans the Commissioner of Corporations has neither the statutory duty nor power to fix, with any degree of mathematical certainty, the fair market value of the securities involved. Concededly, the applicant has the burden of proving that any plan that is submitted is "not unfair, unjust or inequitable", but this should not require a mathematical demonstration. A reasonable approximation should suffice, since in the final analysis the value of securities is a matter of opinion. It should not be necessary for the applicant to demonstrate mathematically that the exchange values of the plan are the only permissible or proper ones. Reasonable men may differ widely as to the prospective earnings of any enterprise, and may consequently have differences of opinion as to the adequacy of the considerations provided in some plans. Consequently, there should be some room for bargaining in any such plan rather than any attempt to apply a rigid mechanical formula. Where full disclosure has been made to shareholders and they have overwhelmingly voted in favor of the plan, and the applicant shows that the value of the securities to be given in exchange has a reasonable relation to the old securities, based on prevailing market prices, earnings and general financial condition, and there is no evidence of gross inadequacy in the considerations provided in the plan, or of bad faith or oppression, it is believed that the Commissioner should not substitute his judgment

as to the exchange values for that of the management and the overwhelming majority of approving shareholders, especially since the dissenting shareholders are accorded a special statutory remedy providing for cash compensation. Legally, the dissenters' right of appraisal is just as much a part of the plan as the offer of new securities and this fact should enter into the Commissioner's administrative determinations. The shareholder has his choice; he may either accept the new securities, or he may receive the fair market value of his shares as judicially determined. He should not be given the further right of obstructing or delaying the plan merely by voicing an objection to the Division of Corporations, especially if the plan is acquiesced in or consented to by shareholders holding an overwhelming majority of the outstanding securities. Otherwise the Act itself could be twisted into an instrument of oppression by one or two unreasonable small shareholders.

In every type of reorganization, whether it involves a voluntary or statutory recapitalization or a merger or consolidation, it is imperative that complete and accurate disclosure of all material facts be made to the shareholders so as to enable them to act on the basis of an informed judgment. Regardless of any requirements of federal law, such disclosure is an essential part of the applicant's burden in proving that the plan is not "unfair, unjust or inequitable" under the Corporate Securities Act. Moreover, in every case of a recapitalization involving outstanding shares, Civil Code section 362a requires that there be submitted to the shareholders, "a concise summary of the proposed amendment and the changes proposed to be effected thereby in the rights of the shareholders". Consequently, although the securities to be issued under the plan are not required to be registered under the Securities Act of 1933, and although the submission to shareholders is exempt from the proxy provisions of the Securities Exchange Act of 1934, the better practice in all cases is to comply substantially with the standards as to disclosure that would be required, generally, by a registration statement and a proxy statement under the federal acts and regulations.

In addition to the foregoing well-recognized types of reorganizations, a permit is required in California in all cases where true exchanges of securities are involved and, moreover, in many cases which do not involve either a "sale" or an "exchange" in the strict sense. Thus, even in the simplest cases of stock split-ups, or a change from par value stock to no-par value stock, or vice versa, where there is

only one class of shares outstanding and no change of any kind is made in the capital or surplus accounts of the issuer, a permit is required under the rules of the Commissioner of Corporations. It is obvious that there is no true sale or exchange in such instances and that the shareholders do not part with any value.⁹⁷

Moreover, it has always been generally recognized that a permit must be obtained in all cases of modifications of the terms of outstanding securities which adversely affect the particular class of securities themselves in a material manner. Thus it is believed that the California Bar, generally, has readily acquiesced in the view that a reduction of the interest rate, or an extension of the maturity date of outstanding obligations,⁹⁸ requires a permit. In such cases it requires no straining to hold that such a modification involves a sale or exchange and constitutes the issuance of a new security, regardless of whether new bonds, debentures or other pieces of paper representing the modified or new securities are issued for the old, or whether the old evidence of the previously outstanding securities are merely stamped or endorsed with an appropriate legend.

On the other hand, the Bar has questioned the extreme extent to which the Attorney General and the Division of Corporations have carried the theory that every change affecting outstanding securities constitutes a new issue. This theory, which for convenience is hereinafter loosely referred to as the "official theory", was developed in a series of opinions of the Attorney General dating back to the late nineteen-twenties.⁹⁹ Prior to the 1945 amendment to the Act, the only

⁹⁷ It has been held in other jurisdictions that the substitution of new certificates for no-par shares for par values shares, without any change in capital, does not constitute a new issue of securities. *E.g.*, *Whitman v. Consolidated Gas* (1925) 148 Md. 90, 129 Atl. 22.

⁹⁸ Similar modifications are held to be new issues of securities by other regulatory agencies, *e.g.*, the Interstate Commerce Commission and the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935. *Securities and Exchange Commission v. Associated Gas & Elec. Co.* (C. C. A. 2d, 1938) 99 F. (2d) 795 (stamping of outstanding certificates extending maturity date constitutes a new issue); Note (1938) 48 YALE L. J. 149. It is to be observed that the Public Utility Holding Company Act, unlike the Securities Act of 1933, is not merely a disclosure act, but requires specific approvals or permits of the Commission in many instances. In this respect the Holding Company Act is more nearly akin to the California Corporate Securities Act than to the Securities Act of 1933. Moreover, the Holding Company Act contains a broader definition of the term "sale" than the Securities Act of 1933. However, it is not believed that any other regulatory agency, or any decision from any other jurisdiction, begins to reach the extreme limits of the California theory as to modifications herein discussed.

⁹⁹ *E.g.*, OP. ATT'Y GEN. Nos. 8385, 8486, 10995.

general formulation of the theory was contained in section 1, Part Two of Chapter 32 (Reorganizations) of the Rules and Regulations of the Division of Corporations. Such section reads as follows:

"SECTION 1. Any contemplated change in an outstanding issue which involves the creation and 'sale' of a new 'security' will require a permit for such new security. Such a change would ordinarily include a change in the interest rate, face amount, maturity dates, nature of security, sinking fund provisions, release provisions, and/or any other substantial change in the property or contractual rights of the security holders."

Under the official theory, if a corporation has two or more classes of shares outstanding and any change is made in the rights of a single class, all classes of outstanding shares are deemed to be reissued.

The following illustrations point up the extreme reach of the official theory.

Example 1. Corporation *A* has outstanding 1,000 shares of \$100 par value 6% preferred stock, and 1,000 shares of common stock. It replaces the 6% preferred stock by an equivalent number of shares of 5% preferred stock, *without any other change whatsoever*. Under the official theory there is a new issue of common stock as well as a new issue of preferred stock. And this despite the fact that the rights of the common shareholders have not been adversely affected in the slightest, but have obviously been materially benefited.

Example 2. Company *X* has issued and outstanding 10,000 shares of 5% cumulative preferred stock, \$100 par value, and 10,000 shares of common stock, \$100 par value. As permitted by law and its charter, the shareholders authorize a new issue of convertible second preferred stock, junior in all respects to the rights of the senior preferred stock, which are not modified in any respect. Under the official theory a permit must be obtained for all *three* classes of stock, since the senior preferred stock is deemed to be "exchanged" for a new issue of preferred stock identical in all respects with the old, even though the rights of the senior preferred shareholders are in nowise disturbed by the creation or issuance of the new class of second preferred stock. One might not quarrel with the view that a permit must be obtained in such cases, not only for the new class of second preferred stock but also for the common stock, since the position of the common shareholders is affected by being made subordinate to an entirely new class of (convertible) second preferred stock. However,

it appears highly artificial to assert that there is either a "sale" or an "exchange" of the undisturbed senior preferred stock in such a situation.

In neither of the instances illustrated above is it essential for the protection of the investing public that *all* the securities mentioned must be deemed to be "reissued", since the Commissioner effectively has control over the entire situation through his jurisdiction over the securities that are unquestionably new. On the other hand, it is hardly conducive to clear legal thinking to hold that the wholly undisturbed securities are also "reissued". They clearly would not be subject to a new, original-issue stamp tax.

Under the official theory it has even been contended that a new issue results, requiring a permit, if a corporation having outstanding only common shares without par value, either reduces or increases the stated value of its shares. Such increase may be accomplished by a transfer of surplus to stated value simply by resolution of the board of directors without any shareholder action.¹⁰⁰ But in any event neither such increase nor decrease is more than a matter of book-keeping, and it is logically absurd to hold that a "sale" or new issue of securities thereby results, since neither the issuer nor the shareholders part with anything and there is no change in their relationship. Likewise it has been contended under the official theory that substantially every change in an indenture requires a permit for the reissue of all securities outstanding thereunder even though the express terms of the obligations themselves are in nowise changed.

Unfortunately, there is no decisional law in this state on the subject. Its total absence, it is believed, is generally attributable to the fact that lawyers have resolved the problem by obtaining permits in numerous instances where they were convinced that no permit was legally required. Security issues usually call for haste. As a consequence no one has been willing to incur the trouble, delay and expense that would be involved in clarifying the problem in the courts. Moreover, no great financial burden is now involved in obtaining a permit in most cases, by reason of the fact that since 1937 simple recapitalizations and modifications involving no increment in capital require a filing fee of only \$25.¹⁰¹

It is believed that prior to the 1945 amendment¹⁰² the Bar gen-

¹⁰⁰ CAL. CIV. CODE § 348c.

¹⁰¹ Cal. Stats. 1937, p. 2322 which added subdivision 12 to section 26 of the Act. Cf. also subdivision 12 of section 26 of the Act as amended by Cal. Stats. 1945, p. 859.

¹⁰² Cal Stats. 1945, p. 859.

erally ignored the extreme implications of the official theory. For example, it is believed that few, if any, permits have been applied for in cases of increases or decreases in stated value of no-par value stock comprising the only class of outstanding security. Also, many lawyers have refrained from filing applications for permits for all securities outstanding under an indenture where waivers of certain provisions of the indenture are obtained for specific transactions, which in nowise change the interest rate, maturity date, or other express terms of the outstanding obligations themselves, and do not impair the underlying security.

Prior to the 1945 amendment to the Act,¹⁰³ which broadened the definition of the term "sale" to include "any change in the rights, preferences, privileges or restrictions on outstanding securities", it was generally considered by the Bar that only material changes adversely affecting outstanding securities themselves, which were essentially equivalent to a sale or an exchange, required a permit. Thus, it would have been generally considered unnecessary to obtain a new permit for the reissue of all outstanding shares of all classes, if an annual sinking fund for preferred shares were waived for a temporary period because of emergency conditions. Moreover, it is believed that few, if any, permits were obtained for the reissue of all outstanding indenture securities where there was a mere relaxation of the release provisions of an indenture for a specific transaction, or a waiver by bondholders of the requirement of certain reports or certificates of experts thereunder.¹⁰⁴

Because of the extremely broad wording of the 1945 amendment, it would now appear that the only safe course to pursue is to obtain a permit for all classes of shares of the issuer, whether outstanding or to be issued, whenever any charter amendment is ef-

¹⁰³ *Ibid.*, amending section 2(a)8 of the Act.

¹⁰⁴ In the public utility field, waivers and relaxations of indenture provisions are not uncommon. While it is always advisable to submit such changes to the Railroad Commission, so far as is known that Commission has never taken the position that any such change, which does not involve any modification of the express terms of the indenture securities themselves, requires a new order for the reissue of all the outstanding indenture securities. The Commissioner of Corporations often requires a provision to be inserted in indentures under his jurisdiction to the effect that no modification of the indenture can be made without his authorization. Such a provision is proper and undoubtedly valid and, moreover, highly effective, since any violation thereof might be criminal. However, it seems a distortion of legal theory to hold that every indenture modification constitutes a reissue of all securities outstanding thereunder.

fected, except, of course, changes in the articles that merely relate to the corporate name, powers, place of business, term of existence, or number of directors. Moreover, as a matter of precaution, practically every modification of an indenture under which bonds, debentures or notes are outstanding, or of a trust agreement or other instrument under which other securities have been issued, may require a permit for the "reissue" of all securities outstanding thereunder, even though the terms of the securities themselves are not changed and the rights of the holders thereof are not adversely affected in any material respect. It is even arguable under the official theory that indenture changes may possibly require a permit also for the reissue of all outstanding junior securities.

While it is doubtful that either the Division of Corporations or the Attorney General will take such an extreme position, it might even be argued, under the 1945 amendment, that if a California corporation has only preferred and common shares outstanding, and desires to originally create a bond issue under an indenture containing certain restrictions on the payment of dividends on shares, the corporation must obtain a permit not only for the new bonds, but for the "reissue" of both classes of outstanding shares as well. In such case there is no true "offer", "sale" or "exchange" to or with the existing shareholders. No title passes and the shareholders give no "value". Generally speaking, under California law, they do not even have any vote with respect to the bond issue, any more than shareholders have any right to vote in simple cases of increases of stated value of non-par shares.

Pushed to its logical absurdity, the 1945 amendment might require a permit for the reissue of all outstanding shares of a corporation, if it created one of the long-term bank loan agreements, currently in vogue, which customarily contain various restrictions on the payment of dividends on outstanding shares, although it is clear that no permit would be required for such bank loan agreement itself.

Even prior to the 1945 amendment which artificially expanded the definition of the term "sale" as set forth above, the jurisdiction of the Commissioner of Corporations would appear to have extended to all modifications of outstanding securities which were truly tantamount to exchanges. While the amendment may have been intended to clarify the problem, it is believed that because of its sweeping language it has added nothing but confusion. As a consequence, at least until the scope of the amendment is delimited by opinions of

the Attorney General, it would appear that the cautious course to pursue is to obtain a permit for every doubtful case.

There remains the question as to the stage in any reorganization proceeding when the permit must be obtained.¹⁰⁵ Under the rules of the Securities and Exchange Commission, in the case of "reorganizations" which involve "sales" and consequently require registration under the Securities Act of 1933, the registration statement must become effective before the new or modified securities are "sold", and in certain cases before the plan is even submitted to the security holders.¹⁰⁶

Generally speaking, it is not believed that any serious problem is posed under the California Act in reorganizations or modifications involving California issuers, even though the submission of the plan to shareholders and the solicitation of proxies might technically be construed to constitute an "offer", or a "negotiation for the sale of, or a subscription for" a security.

In all reorganizations requiring shareholder approval, it would appear to be an orderly procedure to submit the matter to shareholders and hold the meeting of shareholders prior to the hearing before the Commissioner, so that the result of the vote—which is highly relevant—can be presented to the Commissioner as part of the applicant's showing as to the fairness of the plan.

The conservative procedure is to obtain a simple offering permit¹⁰⁷ before submitting the plan to the security holders, although it is to be emphasized that in every such case a definitive permit must be obtained before the new or modified securities are actually issued.

But even though no preliminary offering permit is obtained there should be no dire consequences in the case of a California issuer, provided one follows the usual and accepted practice in this state of making the submission of every plan of reorganization, whether involving a merger, consolidation, statutory recapitalization, or a mere voluntary exchange, expressly subject to obtaining the authorization of the Commissioner of Corporations. In such case the "offer" is merely a contingent offer, since it is conditioned, first upon the ob-

¹⁰⁵ This question is raised in Sterling, *Amendments to California Corporation Laws, 1937: Readjusting Stock Structure* (1937) 26 CALIF. L. REV. 76, 84-88, and in BALLANTINE, *op. cit. supra* note 95, at 386-7.

¹⁰⁶ Rules as to the Use of Form E-1 (For Securities in Reorganization).

¹⁰⁷ A permit to negotiate for the sale of securities requires only a filing fee of \$15 (§ 26, par. 9). Such permit legalizes offers and preliminary transactions, but does not authorize the actual receipt of the consideration or the issue of the securities.

taining of requisite shareholder approval, and secondly, upon authorization by the Commissioner.

Under California law, an amendment of the articles does not become effective until the certificate of amendment has actually been filed by the Secretary of State.¹⁰⁸ This is likewise true in the case of merger and consolidation agreements, which may be abandoned by the board of directors, without shareholders' action, at any time before such formal filing.¹⁰⁹ In all cases of compulsory statutory recapitalizations and mergers and consolidations, the actual "issue" of the new or modified securities takes place by operation of law at the moment of such formal filing with the Secretary of State. Consequently, no merger or consolidation agreement, or formal amendment of the articles in the case of a compulsory statutory recapitalization, should be filed with the Secretary of State until after the issuance permit of the Commissioner of Corporations has been obtained. If such procedure is followed it would appear reasonably clear that the securities issued under the plan would not be void, although no preliminary offering permit were obtained prior to the submission of the plan to the shareholders. The Act must be construed with common sense, and it would appear absurd to contend that an "offer" made only to existing security holders of the issuer, and expressly conditioned on the obtaining of a permit, could be held to be a criminal or even a technical violation, especially where full disclosure of such "offer" is made to the Commissioner of Corporations before he grants his permit. It is believed that any preliminary technical violation because of such contingent "offer" would be cured by the actual issuance of the permit. Such situation does not involve the ratification of an illegal contract and does not even require the application of the doctrine announced in *Moore v. Moffatt*,¹¹⁰ and *Waring v. Pitcher*,¹¹¹ to the effect that despite a prior illegal subscription agreement, if the securities are not actually issued until after a permit is obtained and if the final act of performance constitutes an independent transaction, the securities are not void.

In cases of mere voluntary recapitalizations there is no legal objection against filing the requisite formal amendment of the articles as a preliminary step, even before any permit of the Commissioner is

¹⁰⁸ CAL. CIV. CODE § 362b.

¹⁰⁹ *Ibid.* § 361.

¹¹⁰ (1922) 188 Cal. 1, 204 Pac. 220.

¹¹¹ (1933) 135 Cal. App. 493, 27 P. (2d) 397.

obtained. The mere permissive amendment of the articles in such cases does not constitute either an offer, sale, or exchange, and the "offer" cannot be made until after such amendment becomes effective. Of course, in such cases neither the offer should be made nor should the securities to be issued pursuant to the exchange offer be actually issued, until after a definitive permit is in hand.

The more difficult problem in connection with reorganizations by foreign corporations having shareholders scattered throughout the various states, including California, will be subsequently considered.

SECURITIES ISSUED BY INDIVIDUAL ISSUERS

The concept of the "individual issuer" has been developed to a unique degree in California for the reasons hereinafter explained. It is also interwoven with the problem of separate securities issued by different issuers evidencing substantially the same interest in a single underlying *res*, which is discussed under a succeeding caption.

With one exception, the Securities Act of 1933 requires registration only with respect to an original primary distribution of securities.¹¹² The single exception applies to a secondary distribution, through an underwriter, by a controlling person, who is, by definition, also an "issuer" for the sole purpose of section 2(11) of that statute.

Many state securities acts do not exempt either interstate or intrastate secondary distributions of securities, whether by a dealer or private owner. And it has been generally held that regulation of security sales, even in the case of a private owner who is not an issuer, is within the police power.¹¹³

In contrast, the permit provisions of the Corporate Securities Act apply only to original issues of nonexempt securities by an issuer.¹¹⁴ No permit is required for resales by dealers, or even for bona fide sales in a secondary distribution by an affiliate of the issuer or a person in a control relationship with the issuer, provided it is clear that the securities were originally validly issued and are bona fide outstanding.

¹¹² Certain problems arise pending the completion of the primary distribution, such as unsold original allotments, which are not relevant here.

¹¹³ Notes (1934) 22 CALIF. L. REV. 341; (1937) 10 SO. CALIF. L. REV. 483, 489.

¹¹⁴ Treasury shares which constitute the only real or apparent exception are treated under a subsequent caption.

Moreover, California, in the famous case of *People v. Pace*,¹¹⁵ early established a rule contrary to the majority rule that regulation of security sales by a private owner, who is not an issuer, is within the police power. Under the rule of that case, a private owner of outstanding securities is not even required to obtain a dealer's license before selling such securities for his own account, and *a fortiori* is not required to obtain a permit.

Some of the most troublesome questions in connection with the Act arise out of the rule of the *Pace* case, and the seemingly hopeless confusion in the decisions is inexplicable without a clear understanding of the holding of that case and its subsequent legislative and judicial history. The effort on the part of the courts to limit the doctrine of the *Pace* case undoubtedly explains to a large extent the readiness with which the courts, on a pragmatic basis, hold individuals and others to be issuers of a new or original security in transactions which on their face are apparently only transfers of already existing securities. As stated by the supreme court in *Domestic & Foreign Pet. Co. v. Long*,¹¹⁶

"The state may control the issuance of securities by corporations under its power to regulate corporations, which exist under charter from the state. Its right to regulate the *individual issuer* of securities presents a different problem . . . Securities originally issued in *bona fide* private transactions may subsequently be offered to the public. In this state, where the rule of *People v. Pace*, *supra*, prevails, limiting the right of the state to require an individual who is neither the issuer nor underwriter to obtain a permit to sell personally owned securities . . . it is of special importance that the corporation commissioner should have authority to investigate all securities *at the time of their original issuance*. . ." (Italics added.)

In the case of *People v. Pace* it was held that a natural person owning securities of which he is not the issuer or underwriter may sell such securities for his own account without procuring a dealer's license from the Commissioner of Corporations. In that case, the defendant disposed of certain shares which he owned, in sixteen different sales covering a period of five months, without procuring a broker's (dealer's) certificate. Defendant was concededly the bona fide owner of the shares and no question was raised as to whether he was a dealer in securities or whether he purchased the securities

¹¹⁵ (1925) 73 Cal. App. 548, 238 Pac. 1089.

¹¹⁶ *Supra* note 71, at 558, 51 P. (2d) at 77.

as a subterfuge to avoid the Act. The only question before the court was whether the section of the Act as it then stood was unconstitutional in attempting to regulate a bona fide owner in selling his personally-owned securities in "repeated and successive transactions". At that time (1923) section 2, paragraph 9(a) of the Act exempted from its provisions certain transactions, including "... any owner of any security who is not the issuer or an underwriter thereof, who sells or exchanges the same for his own account; provided, that such sale or exchange is not made in the course of repeated and successive transactions of like or similar character by him." The court held the proviso to be unconstitutional and void, holding that if a man owns securities he can dispose of them as freely as any other property which he may own.

The rule of the *Pace* case was reaffirmed a few years later in the case of *People v. Lesser*,¹¹⁷ and has been recognized by countless cases in the appellate courts, including the California supreme court,¹¹⁸ and would appear to be established too firmly to be changed at this late date.¹¹⁹ The Act has been amended several times since the decision of *People v. Pace*, with the view of restricting the rule laid down in that case. In 1923 the Act was amended to require individual issuers to secure permits before offering their securities to the public.¹²⁰ Also, in 1929 the legislature, in amending the Act in so far as it relates to individual issuers, eliminated from the definition of "security" the phrase "offered to the public".¹²¹

The courts have sustained the constitutionality and validity of the regulation provided by the Act requiring an individual issuer to obtain a permit before offering securities of his own issue to the public¹²² and, since the 1929 amendment to the Act, even before disposing of securities in a single private transaction.¹²³ The extreme reach of the rule is illustrated by the recent decision of the California supreme court in *People v. Sidwell*.¹²⁴ In that case a single private transaction involving an interest in an oil and gas lease was held to be an

¹¹⁷ (1932) 123 Cal. App. 489, 11 P. (2d) 668.

¹¹⁸ Domestic & Foreign Pet. Co. v. Long, *supra* note 71.

¹¹⁹ (1937) 10 So. CALIF. L. REV. 483, 489.

¹²⁰ Cal. Stats. 1923, c. 50, p. 87.

¹²¹ Cal. Stats. 1929, c. 707, § 2, par. 7, p. 1252.

¹²² *People v. Craven* (1933) 219 Cal. 522, 27 P. (2d) 906.

¹²³ Domestic & Foreign Pet. Co. v. Long, *supra* note 71. See also Cecil B. deMille Productions v. Woolery (C. C. A. 9th, 1932) 61 F. (2d) 45 and Note (1937) 10 So. CALIF. L. REV. 483.

¹²⁴ *Supra* note 81.

issue by individuals in criminal violation of the Act. Accordingly, it is clear that any individual issuing securities of his own issue in California must obtain a permit and any such securities issued without a permit or in violation of a permit are void.

The sham and evasion cases previously discussed¹²⁵ are consonant with the foregoing rule in that in each such case the seller, while purporting to be the owner of already validly issued securities, was in reality merely the agent or *alter ego* of the corporation-issuer on whose behalf the sales were made, or a trustee of a naked trust for the benefit of the corporation. In those cases the defendants were not true individual-issuers of primary interests as in the *Craven*, *Long* or *Sidwell* cases. The true rationale of the evasion cases is that the corporation itself, through its agent or *alter ego*, was issuing its shares within the state without a permit. That line of cases is chiefly of interest in demonstrating the extent to which the courts readily go in holding someone in addition to the technical issuer to be also an issuer within the meaning of the Act, when there is clearly fraud, bad faith, or an evident intent to evade the Act.

The doctrine of the *Pace* case has therefore been limited by statutory amendments and by the decisions, and substantially the entire field of sales of securities has been placed under regulation. All original issues, whether by corporations, trustees or individuals, fall within the permit provisions of the Act, and resales of already outstanding securities by dealers are governed by the dealer regulation provisions of the Act. Nonregulation is confined solely to the following transactions: (a) sales by a bona fide owner of securities issued by another for his own account when made by himself but not as a regular business, provided such sales do not otherwise violate the provisions of section 2(c)3 of the Act;¹²⁶ (b) sales by a bona fide holder of personally-owned securities issued by another for his own account through an agent without a license only when the agent is not compensated. Even a bona fide owner of securities issued by another may not sell such securities through an agent for compensa-

¹²⁵ *E.g.*, *People v. Eiseman*; *People v. Smith*, both *supra* note 82; *People v. Ratliff*, *supra* note 83; *People v. Murphy*, *supra* note 84.

¹²⁶ Section 2(c)3 of the Act provides as follows: "The sale of securities when made by or on behalf of a vendor not the issuer or the underwriter thereof who, being the bona fide owner of such securities, disposes of his own property for his own account, and such sale is not made, directly or indirectly, for the benefit of the issuer or an underwriter of such security, or for the direct or indirect promotion of any scheme or enterprise with the intent of violating or evading any provision of this act." (Italics added.)

tion unless such agent is licensed, nor could such individual owner of securities sell personally-owned securities without obtaining a dealer's license if he goes into the regular business of selling to the public. However, if the individual owner is the issuer of the securities, he must obtain a permit whether the securities are offered to the public or sold in private transactions.¹²⁷

THE POSITION OF AN UNDERWRITER

The term "underwriter" is not defined in the Act. Moreover, at all times since its inception the Act has used the words "underwriting" and "underwriter" only in its dealer regulation provisions, and specifically only in two places, *viz.*, in the definition of the word "broker", and in the provision exempting persons who sell personally-owned securities issued by others from the requirement of obtaining a "broker's" certificate. Strictly speaking, neither of these words is used in the Act in any connection with its permit provisions. This is made clear by the legislative history of the Act. The Act, as amended in 1923, and as in existence when the case of *People v. Pace* arose, defined the word "broker" in paragraph 9 of section 2. Such definition included every person who, among other things, engaged in the business "of underwriting any issue of securities" issued by others. The same paragraph 9 expressly excepted from the provisions thereof, "any owner of any security who is not the issuer or an underwriter thereof who sells or exchanges the same for his own account"

In subsequent amendments of the Act the paragraph defining the word "broker" has been differently numbered and slightly expanded. The present Act defines the word "broker" in section 2(a)10. Also, the exception in respect of sellers of personally-owned securities issued by others has been restricted and is now found in section 2(c)3 of the Act. Despite the generality of its language, it would appear clear that this exception is merely designed to relieve such sellers from any requirement of obtaining a "broker's" certificate. It has no reference to the permit provisions, since only an issuer is required to obtain a permit. Subdivision (c) sets forth the transactions which are exempt from the Act and paragraph 3 of the subdivision now reads as follows:

"3. The sale of securities when made by or on behalf of a vendor not the issuer or an underwriter thereof who, being a bona fide owner

¹²⁷ See BALLANTINE, *op. cit. supra* note 95, at 384; Note (1937) 10 So. CALIF. L. REV. 483, 489.

of such securities, disposes of his own property for his own account, and such sale is not made, directly or indirectly, for the benefit of the issuer or an underwriter of such security, or for the direct or indirect promotion of any scheme or enterprise for the intent of evading or violating any provision of this Act."

In essence, this means simply that any person other than an issuer, underwriter or dealer, may sell personally-owned securities issued by others, for his own account, without obtaining a "broker's" certificate. Obviously, an underwriter must have such a certificate even though he sells, as a principal, for his own account, securities issued by others. Moreover, it is indisputable that the exemption, despite its literal wording, does not extend to any dealer in securities. This is made abundantly clear by the definition of the word "broker" in paragraph 10 of subdivision (a) of section 2, since the word "broker" includes "every person . . . other than an agent, who shall, in this State, engage . . . in the business of selling . . . or otherwise dealing in any security issued by others . . . or of underwriting any issue of such securities, or of purchasing such securities with the purpose of reselling them, or of offering them for sale to the public."

Under the Act the term "underwriter" may have either of two meanings. First, it may mean a person who purchases, as a principal, from the issuer an entire new issue of securities with the view of reselling such securities to the public. Secondly, it may mean a person who, prior to the issue or public offering of new securities, agrees with the issuer to purchase at a stipulated price such part of the securities as are not subscribed for by others.¹²⁸ This is the so-called "standby" arrangement under which, generally, the underwriter is compensated at a specified rate for all securities proposed to be issued, including those actually subscribed, and binds itself to purchase the unsubscribed securities at a discount below the initial public offering price.

In either event the underwriter acts as a principal, and in either event it would appear clear that the underwriter itself need not obtain a permit. But it must, of course, be a licensed "broker" (dealer). In short, an underwriter under the Act is a dealer who purchases new securities directly from the issuer with the definite view of re-

¹²⁸ This latter meaning appears to have been the most common meaning of the term prior to the enactment of the Corporate Securities Act. *Cf.* *Rauer's Law and Collection Co. v. Harrell* (1916) 32 Cal. App. 45, 162 Pac. 125, and see, generally, 1 FLETCHER, *CYC. CORPS.* (Perm. ed. 1931) 750, *et seq.*

selling them to the public. Within the purview of the Act one who merely acts as agent for the issuer is not an "underwriter". A person acting in that capacity alone would not be required to obtain a "broker's" certificate, but only a license as agent for the issuer.

No case has been found that squarely presents the question of the liability of an underwriter where there has been violation of the permit provisions of the Act. This problem will be considered under a subsequent caption dealing with persons who are liable.

The term "underwriter", as used in the Securities Act of 1933, is a word of art with a highly specialized meaning. Section 2(11) of that act defines the term as follows:

"The term 'underwriter' means any person who has purchased from an issuer with a view to, 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 undertaking"

Under that act the term "underwriter" includes a person who merely acts as an agent of the issuer in facilitating the distribution of the security issue without assuming any risk as a principal. Moreover, under such definition a person may be an "underwriter" even though he acts gratuitously and without authorization of the issuer if he actively solicits or participates in the distribution of a security issue.¹²⁹ In contrast, as above stated, under the California Act it is believed that one who merely acts as agent for the issuer is not an "underwriter".

Section 2(3) of the Securities Act of 1933 in its definition of the term "sale" expressly excepts "preliminary negotiations or agreements between an issuer and any underwriter." The Corporate Securities Act does not expressly except such preliminary negotiations. However, as previously explained, it is believed that as a matter of general practice offering permits are rarely sought, or needed, merely for the purpose of legalizing preliminary transactions between the issuer and an underwriter.

WHO IS THE ACTUAL "ISSUER"?

In many situations it is difficult to determine who is the actual issuer of a security. In several of the cases, the courts apparently

¹²⁹ Securities and Exchange Commission v. Chinese Consol. Benev. Association (C. C. A. 2d, 1941) 120 F. (2d) 738.

resolve this problem with apparent facility by holding that more than one security may be issued by different issuers evidencing substantially the same economic interest in one underlying *res*, regardless of whether the underlying *res* is a corporate security, a beneficial interest, or some other form of "interest" or property.

The simplest illustration of this rule is the typical voting trust certificate.¹³⁰ In California, the issuing corporation must obtain a permit for the issuance of its shares. If the shares are then placed in a voting trust, whether simultaneously with or subsequent to the actual issue of the primary shares by the corporation, the voting trust certificates constitute a security separate and distinct from the primary shares, even though both represent substantially the same economic interest except for the voting power attached to the shares. The voting trustees are therefore issuers of a security and they must also obtain a permit from the Commissioner.

Certificates of deposit for a security are somewhat analogous.

¹³⁰ Despite the query raised in a recent Note [(1945) 33 CALIF. L. REV. 321], it would appear too clear to merit elaboration that voting trust certificates constitute separate securities within the meaning of the Act and require a permit. While the Act itself does not expressly enumerate voting trust certificates in its definition of the term "securities", nevertheless the legislature must have contemplated that they are covered by the Act since section 26-1(c) expressly provides the basis for the computation of the filing fee in connection with an application for a permit for voting trust certificates. The only appellate case in this state which has squarely considered the problem held that voting trust certificates issued without a permit are void. *Barney v. First National Bank of Monterey* (1939) 90 P. (2d) 584. (First District Court of Appeals, Division Two, not officially reported. After transfer to the supreme court appeal dismissed pursuant to stipulation.) It is not believed that the recent case of *Boericke v. Weise* (1945) 68 Cal. App. (2d) 407, 156 P. (2d) 781, *hearing den.* (May 10, 1945), constitutes any real authority to the contrary. As a matter of fact, the court in that case refused to exercise its judicial function and did not really pass on the point because of the conduct of counsel. The Division of Corporations has consistently and continuously construed voting trust certificates to be securities under the Act. The rules and regulations of the Division make specific reference to applications for voting trust certificates. (Rules, c. 32, pt. 2, § 17.) Moreover, the files of the Division show that the Bar generally recognizes that voting trust certificates constitute securities within the Act. Numerous applications have been filed and permits granted for voting trust certificates, including cases involving primary shares which are themselves exempt, such as bank shares, etc. For other purposes, voting trust certificates are quite commonly recognized to be separate securities. They are expressly included within the definition of the term "security" contained in the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935. The transfer of voting trust certificates is subject to federal stamp tax. Regulations 71, § 133.33. *Cf.* also *Orpheum Building Co. v. Anglim* (C. C. A. 9th, 1942) 127 F. (2d) 478, and Note (1939) 118 A. L. R. 1292. Finally, the business world, including the national securities exchanges and businessmen generally, recognize voting trust certificates as being separate and distinct securities.

The committee or trustee issuing the certificate of deposit for a security is an issuer and must obtain a permit before issuing such certificates of deposit. In other cases, contracts involving shares of corporate stock have also been held to be securities separate and distinct from the stock itself.

In the case of *People v. Oliver*,¹³¹ the defendant had issued contracts over his own signature in which he undertook to organize a corporation, convey to it patent rights and have it issue its shares which would then be distributed pro rata to the parties to the contract. It was held:

"The contract itself forms a security of his own issue, even though it offers to the subscriber shares of stock in the corporation to be organized, *as it goes beyond the mere sale of stock of the proposed corporation*. . . . The fact that the subscriber was to receive shares of stock of the corporation does not make the transaction one of the mere sale of the corporate stock, which was but one of its incidents. The security sold was one of the issue of appellant himself and not of the Oliver Electric Power Corporation. Such being the case, the verdict of not guilty of the charge of sale of the corporate security is not inconsistent with the verdict of guilty of the sale of the security issued by appellant."¹³² (*Italics added.*)

Also, in situations such as are involved in the previously mentioned cases of *People v. Murphy*, *People v. Smith*, and other kindred evasion cases,¹³³ where there is either a naked trust or a sham transfer and the corporation is in effect the owner of everything except bare record title, the courts often hold the promoter "purchaser" to be an issuer when he sells such securities to the public.

More complex situations involve beneficial interests in property other than corporate securities, but even in such situations the courts have no difficulty in holding trustees and individuals to be issuers,¹³⁴ although purporting merely to transfer a previously created interest.

A leading case on individual-issuers is the supreme court case of *Domestic & Foreign Pet. Co. v. Long*,¹³⁵ in which it was held that an individual owner of an oil lease who assigned in the form of a

¹³¹ (1929) 102 Cal. App. 29, 282 Pac. 813.

¹³² *Ibid.* at 40, 282 Pac. at 818.

¹³³ *Supra* notes 83-86.

¹³⁴ The most important of these cases are *In re Girard* (1921) 186 Cal. 718, 200 Pac. 593; *Barrett v. Gore* (1928) 88 Cal. App. 372, 263 Pac. 564; *People v. Ferguson* (1933)

134 Cal. App. 41, 24 P. (2d) 965; and *People v. Craven*, *supra* note 122, all of which are cited in the case of *Mary Pickford Co. v. Bayly Brothers, Inc.*, *supra* note 79, at 513.

¹³⁵ *Supra* note 71.

grant deed, at private sale without a public offering, fractional interests of overriding royalties in the oil and gas to be produced during the term of the lease, was an issuer of securities within the meaning of the Act. This case went further than any other previous case in holding that assignments of interests made by individual owner-issuers in the ordinary course of business without any offering to the public are issues of a security under the Act for which a permit must be obtained.¹³⁶

The decisions in *Mary Pickford Co. v. Bayly Bros., Inc.*¹³⁷ and companion cases also illustrate the difficulty in determining the question as to who is the actual issuer of securities consisting of beneficial interests. While the facts in that case are extremely involved, the essential ones bearing on the question as to who is the issuer are as follows: Bayly Brothers, Inc. and Edwards & Wildey Company together formulated a plan to promote and finance a real estate subdivision. They obtained an option on the so-called "Sunshine Ranch" and transferred this contract to Suburban Estates, Inc., a corporation which they formed for that purpose. Such corporation issued its shares to the California Trust Company as trustee pursuant to a permit of the Commissioner of Corporations, and also conveyed the Sunshine Ranch to the trustee under a trust by which the proceeds of the sale of lots were to be applied in part to various specified purposes and the balance distributed to Bayly Brothers, Inc. and Edwards & Wildey Company who were named as the sole beneficiaries. Bayly Brothers, Inc. and Edwards & Wildey Company solicited subscriptions to fractional beneficial interests in the project and even collected subscription moneys prior to the actual declaration of the trust, but actually assigned fractional beneficial interests only after the creation of the trust. Several of the subscribers brought action against Bayly Brothers, Inc. and Edwards & Wildey Company and others on the grounds that no permit had been granted for the issuance of the securities. (In this case there was also a count of actual fraud, which has no bearing on the immediate question.) The principal defense of the defendants in meeting the charge that the securities had been issued without a permit of the Commissioner of Corporations was that under the law of California as it existed up

¹³⁶ See, on this general subject, Note (1937) 10 So. CALIF. L. REV. 483. In the more recent case of *People v. Sidwell*, *supra* note 81, even a criminal conviction was sustained in a similar situation.

¹³⁷ *Supra* note 79.

to August 14, 1929, any security issued by a state bank or trust company operating in California, whether against its own assets or merely in its capacity as trustee, was exempt under the Act and no permit was required with respect thereto.¹³⁸ As to this contention, the court held that the assignment of fractional beneficial interests by Bayly Brothers, Inc. and Edwards & Wildey Company, although in form purporting to be a mere "transfer and assignment", constituted the issue of a new security of which Bayly Brothers, Inc. and Edwards & Wildey Company were the issuers. Apparently the ground of the decision is that even though the declaration of trust by the trust company constituted the issue of a security (*viz.*, the entire beneficial interest) which was exempt under the Act, nevertheless, Bayly Brothers, Inc. and Edwards & Wildey Company themselves were issuers of a new and distinct security. The supreme court rejected a finding of the trial court that the trust company issued the securities as only a conclusion of law which was incorrectly drawn from the admitted facts and therefore must be disregarded. Among other things, the court stated:

"This constituted the issuance of a security; it was a *new interest* created by Bayly Brothers, Inc. and Edwards & Wildey Company in the property owned by them. Unquestionably, the certificates executed by Bayly Brothers, Inc. and Edwards & Wildey Company were securities within the meaning of the Corporate Securities Act The evidence shows that the trust company did not execute the certificates of fractional interest nor did it have any interest in the property represented by them. Under such circumstances it clearly was not a co-issuer of the certificates

"The conclusions just stated are not contrary to those reached in *Fox-Woodsum Lumber Co. v. Bank of America*, etc., 7 Cal. (2d) 14, *Vandervort v. Farmers etc. National Bank*, 7 Cal. (2d) 28, and *Miller v. Union Bank & Trust Company*, 7 Cal. (2d) 31. In the last case the question of the liability of the bank arose upon demurrer to the complaint which alleged that it 'issued and sold' the securities there involved. The decision necessarily assumes those facts but the defendants point out that exhibits attached to the complaint show the issuance and sale of fractional parts of a trust interest in substantially the same form as the transaction complained of in the present case. If it be assumed that these exhibits could negative the

¹³⁸ *Miller v. Union Bank & Trust Co.* (1936) 7 Cal. (2d) 31, 59 P. (2d) 1024. The court had previously held in the leading case of *Young v. Three For One Oil Royalties* (1934) 1 Cal. (2d) 639, 36 P. (2d) 1065, and in *Fox-Woodsum Lumber Co. v. Bank of America N.T. & S.A.* (1936) 7 Cal. (2d) 14, 59 P. (2d) 1019, that any security issued by a national bank, prior to August 14, 1929, was exempt under the Act.

allegations of the complaint, it is sufficient to point out that *no contention was made that the assignments of fractional interest constituted the issuance of a new security.*"¹³⁹ (Italics added.)

Despite the statement of the court that the conclusions are not contrary to those recognized in *Miller v. Union Bank & Trust Co.*,¹⁴⁰ the holding in that case must be deemed to be greatly weakened by the decision in the *Pickford* case in factual situations comparable to those in the latter case, which would appear to extend the jurisdiction of the Commissioner farther than had ever been done before. The declaration of trust by the California Trust Company created the beneficial interest. In holding that the attempted assignment and transfer of fractional beneficial interests by the owners of the entire beneficial interest after such entire beneficial interest had been fully and completely created was not a mere transfer but constituted the issuance of a new security, the court did not even stress the fact that subscriptions had been taken prior to the actual declaration of the trust. The only possible ground for distinguishing the *Pickford* case from the *Miller* case lies in the fact that in the *Pickford* case the entire beneficial interest in the trust was vested in Bayly Brothers, Inc. and Edwards & Wildey Company as sole beneficiaries, and by reason of the fact that they thereafter carved out lesser interests to sell to the public, they became the issuers of a security separate and distinct from the security (*i.e.*, the entire beneficial interest) issued by the trust company in its declaration of trust.¹⁴¹ The court even held that the trust company was not a co-issuer of the fractional interests involved, although it was also held liable because of its participation in the "general scheme" to issue and sell such fractional interests.

Other considerations may have influenced the court in arriving at its decision, particularly the fact that the original sole beneficiaries of the trust not only risked none of their own money but took substantial profits out of the transaction. The decision on the strict point holding Bayly Brothers, Inc. and Edwards & Wildey Company to

¹³⁹ *Mary Pickford Co. v. Bayly Bros., Inc.*, *supra* note 79, at 513, 515, 86 P. (2d) at 107, 109.

¹⁴⁰ *Supra* note 138.

¹⁴¹ *Cf.* the definition of "issuer" in the Securities Act of 1933, § 2(4); ". . . with respect to fractional undivided interests in oil, gas or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether all or fractional) who creates fractional interests therein for the purpose of public offering." 48 STAT. (1933) 74, *ibid.* (1934) 905, 15 U.S.C. (1940) § 77b(4).

be the issuers of a new security is explainable chiefly on pragmatic grounds and illustrates the ease with which the courts are willing to find that more than one security may be issued by different issuers evidencing substantially the same interest in one underlying *res* if this becomes necessary to accomplish the result deemed desirable by the court.

TREASURY SHARES

Treasury shares¹⁴² constitute the sole exception to the basic rule that a permit is required under the Act only for an original issue of securities. Whether such exception is real or only apparent depends on whether a disposition of treasury shares is merely a resale by the issuer of already issued and outstanding shares that have previously come into existence, or constitutes a new original issue for the purpose of the Act.¹⁴³

Section 3 of the Act prohibits the *sale* without a permit, by any company of any security of its own issue. Since a sale of treasury shares is, by definition, a sale of reacquired shares by the corporation which originally issued them, it is clear that such sale requires a permit, regardless of whether or not it constitutes a new original issue.¹⁴⁴ Therefore, such sale without a permit would be illegal, and

¹⁴² Treasury shares are defined by California Civil Code section 278 to mean "shares issued and thereafter acquired by the corporation but not retired or restored to the status of unissued shares." The courts have frequently defined the term "treasury shares" in a loose and incorrect manner, and have erroneously applied it to authorized shares which have never before been issued and are subject to future original issuance by the corporation. See *Tatterson v. Kehrlin* (1927) 88 Cal. App. 34, 263 Pac. 285, in which the term is so used erroneously in a case involving the Act. See also, generally, BALLANTINE, *op. cit.* *supra* note 95, at 182 *et seq.*

¹⁴³ The accounting treatment of treasury shares has been widely divergent. Moreover, the decisions dealing with treasury shares in other jurisdictions and under other branches of the law are in hopeless conflict. It is not believed that the decisions involving taxes or other fields of law are of particular help for the purpose of construing the meaning of the Act. In the field of federal income tax, the question has had an interesting history. For many years the sale of treasury stock was deemed to be a capital transaction. The regulation was subsequently amended by Treasury Decision [T. D. 4430 (1934) XIII-1 CUM. BULL. 36] and Mr. Robert Jackson, now an Associate Justice of the United States Supreme Court, while general counsel for the Bureau of Internal Revenue, rendered an opinion in which he stated that upon the sale of treasury stock "*there was no new issuance of stock and no intention to issue new stock . . .*" [G. C. M. 12955 (1934) XIII-1 CUM. BULL. 107]. See, also, *Helvering v. R. J. Reynolds Tobacco Company* (1939) 306 U.S. 110, in which the Supreme Court refused to recognize the retroactive application of the amended regulation. See, also, the recent case of *Kirschenbaum v. Commissioner* (C. C. A. 2d, 1946) F. (2d), 46-1 U.S.T.C. No. 9231, in which shares purchased to be "held by the corporation as treasury stock, subject to resale," were held to be redeemed and cancelled for tax purposes.

¹⁴⁴ It is of interest to note that the Securities and Exchange Commission has taken

possibly even a crime under the Act, but the more difficult question is whether the security itself is void in such case.

The voiding section of the Act (section 16) provides that "every security issued by any company, without a permit," shall be void. The Act does not use the word "void" in any other connection. Moreover, it seems obvious that the term "issue" in section 16 is used in its ordinary sense of an original coming into existence.

The language of the two sections is plainly different. Under a strict and literal reading of section 16, a sale of treasury shares without a permit would not render the securities void.

The legal consequences are of course quite different if merely the sale of treasury shares is illegal than if the treasury shares themselves are void. For instance, in the former case the immediate vendee alone could recover. On the other hand, if the shares themselves are void, no privity would be required and subsequent assignees would have a right of recovery.

The only California case squarely in point is *Castle v. Acme Ice Cream Co.*,¹⁴⁵ decided by the district court of appeal, in which it was held that a disposition of treasury shares without a permit renders the securities void. While the result reached in that case seems correct, since it was based on several other unquestionable grounds, the reasoning on the specific point that treasury shares sold without a permit are void, is highly unsatisfactory. In that case the president of the corporation donated to it some of its outstanding shares, which apparently had been validly issued pursuant to a permit, to enable it to complete a contract to acquire another going concern, and the corporation delivered such shares without obtaining a new permit. The opinion does not indicate the exact terms on which the president surrendered the shares to the corporation and the court's holding that the shares involved were treasury shares, lacks conviction. Moreover, the court actually misquoted the voiding section of the Act. Finally, the specific holding was not necessary to the decision.

The Division of Corporations has continuously and consistently construed the Act as requiring a corporation to obtain a new permit to sell its treasury shares even though such shares were originally validly issued pursuant to a prior permit. Such conclusion is clearly

the position that treasury stock originally issued before the effective date of the Securities Act of 1933, must be registered under that Act before it may be sold. Release No. 131, March 13, 1934.

¹⁴⁵ (1929) 101 Cal. App. 94, 281 Pac. 396, *hearing den.* (Dec. 2, 1929).

compelled by section 3 of the Act standing alone. However, it is not understood that the Commissioner of Corporations has ever expressly ruled, or even had the occasion to rule, that treasury shares sold without a permit are void. It would seem wholly unnecessary for the Commissioner to take such position, since it is in nowise requisite to the exercise of his administrative function. The question whether a sale of treasury shares without a permit renders them void under section 16, or merely illegal as a sale in violation of section 3, is a judicial, and not an administrative, function.

Professor Ballantine, in his highly respected work on California Corporation Laws, makes the following statement:

"The sale of 'treasury stock' is treated under the California Corporate Securities Act as the issue of a security and requires a permit from the commissioner of corporations."¹⁴⁶

The last clause of this quoted statement is indisputable. However, the statement that the sale of treasury shares is treated under the Act as the *issue* of a security, is not free from doubt. It is made without the citation of authority, except a reference to sections 2-7 [section 2(a)7] of the Act, which sets forth the definition of the term "security" and expressly includes "treasury shares" therein.

The California supreme court has never considered the problem and the only appellate decision¹⁴⁷ appears to be weak authority. It is believed that a strong argument can be made under well-established rules of statutory interpretation that the sale of treasury shares without a permit merely results in an illegal sale, but does not render the shares themselves void. The language of section 16 on its face is plain and unambiguous. Under the primary rule of interpretation, the plain language must be applied and enforced exactly as it stands. "In such a case the court is not at liberty to distort the words of the law from their apparent meaning, nor to substitute one word for another and thereby change or reverse the express language of the Act."¹⁴⁸

The legislature did not say, in section 16, that "every security issued *or sold*" without a permit shall be void. It plainly states only that "every security *issued*" without a permit shall be void. "The

¹⁴⁶ BALLANTINE, *op. cit. supra* note 95, at 184.

¹⁴⁷ *Castle v. Acme Ice Cream Co.*, *supra* note 145, at 98, 281 Pac. at 398.

¹⁴⁸ BLACK, *INTERPRETATION OF LAWS* (1911) 142.

express mention of one . . . consequence is tantamount to an express exclusion of all others.”¹⁴⁹

From a literal reading of the two sections it appears that the legislature deliberately excluded the sale of treasury shares from the voiding section, although it prescribed at the same time the requirement of a permit for the sale of treasury shares. Moreover, the application of the letter of the law in this instance does not involve an effort “to make a fortress out of a dictionary.” A strict reading of the law is not inconsistent with the purpose of the Act, since the fundamental policy of the Act is not to render void any security which has previously been legally issued. Such literal reading of the language in nowise detracts from the jurisdiction of the Commissioner, because a permit must nevertheless be obtained and the Commissioner retains full power to require a corporation to receive a fair consideration on the sale of its treasury shares and otherwise make such sale under circumstances that are not “unfair, unjust or inequitable”.

Treasury shares do not include shares purchased out of capital.¹⁵⁰ Nor are they *new* shares since, by definition, they are shares which have previously been validly issued. Since neither the purchase nor sale of treasury shares is reflected in the capital account of the corporation, there does not seem to be the same need for rendering the securities void without a permit as there is in the case of an original issue of new shares whereby a corporation raises capital.

Limitation of rule as to treasury shares.

Civil Code section 342, which is applicable only to domestic corporations, is not limited to direct acquisitions or purchases of its own shares by an issuer. The restrictions contained in that section expressly extend to indirect acquisitions and to purchases by a subsidiary of shares of its parent. The purpose of such prohibition is obviously to prevent manipulation and the evasive use of capital in the purchase of shares.

In contrast, the Corporate Securities Act—which applies equally to the sale of treasury shares in California by a foreign corporation as well as by a domestic corporation—contains no comparable provisions with respect to the disposition of treasury shares. In the absence of fraud or intent to evade the Act, the rule requiring a permit for the sale of treasury shares would appear clearly to be limited

¹⁴⁹ *Ibid.* at 219.

¹⁵⁰ BALLANTINE, *op. cit. supra* note 95, at 183; CAL. CIV. CODE §§ 278, 342a, 342b.

strictly to the primary shares of the specific corporation which actually issued them.¹⁵¹ The term "treasury shares" does not apply to the shares of an auxiliary or subsidiary company.¹⁵²

The corporate entity must be regarded unless the corporate form be unreal or a sham. There would appear to be no justification whatsoever for applying to the sale of treasury shares any rule other than the well-established California rule that bad faith or fraud must be proved before the corporate entity will be disregarded.¹⁵³

Treasury shares are primary shares of the issuer acquired and held under such circumstances as to directly vest title and the entire beneficial interest in such primary shares in the issuer, and entitle it to possession of the stock certificate representing them. To constitute a treasury share the issuer would necessarily have to acquire the power to dispose of one of its primary shares and to transfer full title thereto and the entire beneficial interest therein to another, with the power to deliver a share certificate representing such primary share. Any lesser interest would obviously not constitute a treasury share.

On principle it would appear clear that any security issued by another, or any interest acquired by a corporation which is less than the entire legal and beneficial interest in one of its own primary shares, would not constitute a treasury share. This would follow even though such security issued by another represents substantially the same, and the only, underlying economic *res* as that of an outstanding primary share of such corporation. Many legitimate situations of this type are known in the business world. A typical example was the well-known former Union Oil Associates, which was formed for the exclusive purpose of holding a controlling block of shares of Union Oil Company. Clearly, if Union Oil Company had lawfully acquired any shares of Union Oil Associates, they would not have become treasury shares of the former. The same principle applies to voting trust certificates which constitute a security separate and

¹⁵¹ "Treasury stock is issued and outstanding stock that has come into the possession of the corporation which issued it." 4 THOMPSON, CORPORATIONS (3d ed. 1927) 51.

¹⁵² *Vanderlip v. Los Molinos Land Co.* (1943) 56 Cal. App. (2d) 747, 133 P. (2d) 467. Also, "The statutory term has obviously no application to shares of one corporation held in the treasury of another, and no such application should be made." 6a CAL. JUR. 407.

¹⁵³ "Bad faith, in one form or another, must be shown before the court may disregard the fiction of separate corporate existence." *Hollywood Cleaning etc. Co. v. Hollywood Laundry* (1932) 217 Cal. 124, 129, 17 P. (2d) 709, 711.

distinct from the underlying shares of corporate stock to which they relate. The voting trustees are the issuers of such voting trust certificates as contradistinguished from the corporation-issuer of the primary shares themselves. If a corporation acquires validly issued voting trust certificates relating to its own lawfully outstanding shares, such voting trust certificates would not constitute treasury shares of the corporation, in the absence of fraud or an intent to evade the Act. Title to the underlying shares in such case is vested in the voting trustees and if the corporation which is the issuer of the underlying shares acquires such voting trust certificates, it could not compel the voting trustees to convert or exchange the voting trust certificates into or for a pro rata number of its own free shares. In such case the corporation would merely be buying and selling securities issued by others and not shares of its own issue and, accordingly, no permit would be required for the disposition of such voting trust certificates.

However, here as elsewhere under the Act, substance and not form is controlling. If such transactions were merely devices to enable the corporation to raise capital or were unreal or sham transactions to evade the Act, the courts could and would quickly look through form to substance and hold any such interests, although purportedly securities issued by others, to be treasury shares of the corporation.

Reacquired Bonds.

If a corporation reacquires its own validly issued and outstanding bonds or debentures under such circumstances as to keep them alive, it must, under the strict wording of section 3 of the Act, obtain a new permit before it can resell such reacquired obligations. However, it would appear, even more clearly than in the case of treasury shares, that the sale of reacquired bonds without a permit would not render the bonds void. There are no statutory provisions relating to reacquired bonds. Moreover, the question whether a bond is issued and outstanding is, for all practical purposes, determined from the records of the authenticating indenture trustee. Furthermore, the bond itself is more than merely an evidence of debt. It integrates the debt, which is inseparable from the paper which declares and constitutes it. Accordingly, it would appear clear that even though a permit is required for the sale of reacquired bonds by the issuer, failure to procure such permit would not render the bonds void.

THE PROBLEM OF THE FOREIGN ISSUER

The Act has always expressly defined the word "company" (issuer) to include foreign private corporations.¹⁵⁴ The permit provisions of the Act also clearly prohibit nonresident trustees and individuals from offering, selling or issuing, within this state, securities of their own issue, without first obtaining a permit. However, for convenience, the discussion under this caption will be confined to foreign corporation-issuers, although it is equally applicable to nonresident trustee and individual issuers.

While the Act clearly forbids sales or issues in California without a permit, by foreign issuers, it is equally clear that no part of the Act purports to have any extraterritorial effect. The Act is clearly territorial.¹⁵⁵ In several places it expressly uses the words "within this state". From its inception it has expressly declared that no part thereof shall be construed as a regulation of foreign or interstate commerce except to the extent permitted by Congress.¹⁵⁶ Congress has not preempted the entire field of interstate security issues. Section 18 of the Securities Act of 1933 expressly leaves the jurisdiction of state regulatory agencies over interstate transactions undisturbed.

There can be no doubt that the legislature has, through the Act, exercised to the fullest extent its power over transactions in this state by foreign issuers. The Public Utilities Act, either through oversight or for some unknown reason, presents an interesting contrast. While no foreign public utility can mortgage its property in this state without the approval of the Railroad Commission, the legislature has not clothed that Commission with any power to control issues of stock by foreign public utilities,¹⁵⁷ although it is clear that the legis-

¹⁵⁴ Section 2(a)3.

¹⁵⁵ *Cf. Hayden Plan. Co. v. Friedlander* (1929) 97 Cal. App. 12, 275 Pac. 253, in which it was held that a foreign corporation is not within the Act if it does not issue or propose to issue its securities in California.

¹⁵⁶ Corporate Securities Act of 1917, § 27, Cal. Stats. 1917, p. 686; present act § 34, Cal. Stats. 1931, p. 959.

¹⁵⁷ *Southern Sierras Power Co. v. Railroad Commission* (1928) 205 Cal. 479, 271 Pac. 747. In that case the California supreme court held that the Railroad Commission has no jurisdiction over the issuance of shares of a foreign corporation lawfully engaged in the public utility business in California, since the provisions of the Public Utility Act clearly were not intended to confer such jurisdiction. The *Southern Sierras* case is distinguished in the case of *Gillis v. Pan American Western Pet. Co.* (1935) 3 Cal. (2d) 249, 44 P. (2d) 311, in which the supreme court stated that the Corporate Securities Act expressly confers jurisdiction on the Commissioner of Corporations over the issuance of securities in the state by foreign corporations. The two cases are reconcilable, since both

lature has the power to exercise such control to the extent that such issue transactions take place in this state.

The Act, of course, could not have any extraterritorial force, and while there is no apparent legislative intent to have it operate beyond California, it is clear that any attempt to give it extraterritorial application would be unconstitutional.¹⁵⁸

Therefore, where it is clear that all parts of the transaction, both preliminary acts as well as the actual issue of the security, take place outside California, it is axiomatic that no permit is required. This is equally true even though such securities are thereafter brought into California and resold by anyone other than the issuer itself.

The original distribution of new securities of most medium-sized, and almost all large, corporations is effected on a nation-wide interstate basis. Consequently, practically all such issues are now registered under the Securities Act of 1933. The customary procedure is hereinafter briefly outlined. Any such corporation desiring to issue and sell new securities, enters into an underwriting agreement with one or more underwriters.¹⁵⁹ If the flotation is to be a large one, with many underwriters participating, they enter into a so-called "agreement among underwriters" and appoint one of their members as representative of the entire group and as manager of the public offering. In such case the representative, acting for itself and the other underwriters, enters into the underwriting agreement with the issuer, whereby each of the respective underwriters agrees severally to purchase a specified amount of the new securities. Such underwriting agreements usually provide that the underwriters will initially make a public offering of the securities at a specified price as soon as practicable—usually a matter of hours—after the registration statement shall have become effective, and further provide that the "closing", that is, the actual delivery of the securities to the underwriters against payment by them, will take place at a specified place and time, which is usually three but not more than seven days after the effective date of the registration statement, depending upon various circumstances.

either directly or inferentially held that the legislature has the constitutional power to regulate issues of stock in California by foreign corporations, but in the *Southern Sierras* case the court held that the legislature in enacting the Public Utility Act had not intended to exercise such power, whereas the *Gillis* case held that it has done so in the Corporate Securities Act.

¹⁵⁸ Cf. *New York Life Insurance Co. v. Head* (1914) 234 U.S. 149.

¹⁵⁹ The term "underwriter" is used under this caption in the strict sense of a dealer who purchases from the issuer, as a principal and for his own account and risk.

The obligations of the several underwriters to take delivery of the securities do not constitute firm, irrevocable commitments, but are subject to various conditions, the principal ones being: the becoming effective of the registration statement, the approval of legal matters by counsel and the furnishing of evidence that no material change has occurred in the affairs of the issuer prior to the closing. Often, but not invariably, there is also a so-called market "out" clause which permits the underwriters to withdraw if any unfavorable change occurs in the financial market prior to the closing.

In the "agreement among underwriters", the representative is ordinarily authorized in its discretion to sell, for the respective accounts of all the underwriters, part of the securities to dealers selected by it at a price which represents a concession under the initial public offering price. In such case the representative, on its own behalf and on behalf of the other several underwriters, enters into agreements with the selected dealers. Also underwriters and selected dealers are usually permitted to allow a smaller concession to other dealers or brokers who are members of the National Association of Securities Dealers Inc., and who are not included either in the group of underwriters or the list of selected dealers. It is to be emphasized that while underwriting agreements may be entered into before the registration statement becomes effective, the selling group cannot be organized until the registration has become effective. The exemption of preliminary transactions under the Securities Act of 1933 extends only to underwriters. Offers to sell cannot be made to dealers, and under section 5(a)(1) of that act dealers are even forbidden from making offers to buy, prior to the effective date of the registration statement.

Prior to the public offering the issuer and the representative take all preliminary steps to qualify the securities for offering under the widely divergent securities acts of the various states in which it is proposed to make the offering. This is a tedious, costly and onerous task which will be hereafter discussed at greater length.

In such distributions involving foreign corporation issuers all steps through and including the actual delivery of the securities to the representative, for the account of the several underwriters, take place outside of California, in one of the larger financial centers, and usually in New York City. The stock certificates or bonds, as the case may be, are physically delivered at the closing, the consideration

paid, and title then and there actually passes to the several underwriters.¹⁶⁰

As previously stated, the public offering is ordinarily made shortly after the registration statement becomes effective and usually before the closing. The offering is made only in the various states that have been selected and whose blue-sky law requirements are being met and only by the respective underwriters and dealers who are licensed in such states or who may lawfully make the offer there. While the underwriting agreement is ordinarily not firm, and the public offering is almost always made subject to certain conditions, such as the approval of counsel and acceptance by the underwriters, the transaction has generally progressed sufficiently far before the public offering, to make the underwriters, for all practical purposes the equitable owners, although not the actual legal owners, of the new securities being offered. It is very rarely that there is a failure to hold a closing after a public offering.

Under the circumstances outlined above, the foreign issuer is not required to obtain a permit in California, even though the licensed dealers who offer here do not actually own the securities at the time of their conditional public offering.¹⁶¹ It appears perfectly proper—and highly desirable in securities distributions—for the dealers to be able to make such advance offering, since no harm can result therefrom. If the closing between the issuer and the underwriters is not held, no sale of securities whatsoever will be effected.

In no such case does the foreign issuer itself either sell, offer for sale, or issue, any securities in California. Only licensed dealers *resell* such securities here, and the Act does not require them to secure a permit but only to comply with the applicable dealer regulation provisions, such as making timely submissions of prospectus, advertisements, etc. under section 10 of the Act.

It goes without saying, however, that if the persons making the offer in this state are not true dealers acting for their own account, but are actually agents for the foreign issuer, such issuer must obtain a permit. It is equally clear that the Act fully regulates all steps involved in the issuance of securities by a California corporation. Many

¹⁶⁰ Stamp taxes constitute more than an insignificant part of the expenses of any such flotation. The issuer of course pays the issue tax, while the several underwriters pay the transfer tax for sales to dealers or directly to the investor. Often there are several transfers, and consequent transfer taxes, before the security reaches the hands of the investor.

¹⁶¹ OP. ATT'Y GEN. (N.S.) No. 2780 (1940).

large California corporations, whose securities are widely held on a nation-wide basis and are actually traded in on the New York Stock Exchange, distribute their new securities in much the same manner as that outlined above. The closing and delivery of the securities of such corporations, and even the preliminary negotiations with the underwriters, often take place in New York. However, such corporations, as creatures of the state of California, must obviously obtain permits for the issuance of their securities, regardless of whether they are actually issued outside the state.

In the typical distribution of new securities of a foreign issuer outlined above, it is clear that every one acts only as a principal—the issuer, the underwriters, and the dealers. Both the underwriters and the dealers act for their own account and risk, and there is not the slightest trace of any agential relationship between any of them and the foreign issuer. Neither the issuer nor anyone on its behalf does anything in California. As a consequence no permit need be obtained for the securities of any foreign issuer that are distributed in such manner. As a matter of fact, the files of the Division of Corporations reveal that, on a dollar-volume basis, the overwhelming majority of all new securities sold in this state are distributed in the manner outlined above and without a permit.

Accordingly, the problem as to the foreign issuer is confined to transactions involving *direct* dealings between the issuer and investors in California. Of course, dealings by an agent of a foreign issuer are the acts of the issuer itself.

Issue transactions in securities consist of a series of at least three separate acts, *viz.*, offer, acceptance, and performance by delivery of the securities and payment of the purchase price. However, for the purposes of the Act, only the offer and the delivery are of material significance, since the Act is aimed exclusively at the seller and not at the buyer, and the act of acceptance by the buyer, wherever made, is not illegal.

If the foreign issuer makes no offer in California, and delivery of the securities does not take place here, no permit is required, even though there is an issue of new securities in a direct transaction between the issuer and a California resident. Thus, it is believed that a foreign corporation not doing business in California, can validly distribute a true share dividend to its existing shareholders, including those resident in California, without obtaining a California permit.^{162a}

¹⁶² OP. ATT'Y GEN., October 8, 1929.

Such exemption is based on the theory that no "sale" is involved and, presumptively, that the shares are issued at the place of business of such corporation, although somewhat inconsistently, a domestic corporation, or a foreign corporation with its commercial domicile actually in California, must obtain a permit for a true share dividend, even though no true "sale" is involved. But even in the case of a foreign corporation not doing business in California, if a dividend is declared in an alternative manner, giving the shareholder an option to take cash or shares, a permit must be obtained for the shares to be issued to California residents who elect to take shares. In the latter case there is clearly a sale, since the shareholder becomes a creditor and by exercising his option furnishes the consideration for the sale by a cancellation of the pre-existing indebtedness.

Extremely complex situations arise in interstate transactions when one or more of the separate acts, either offer, acceptance or performance, occur in different states. In such cases the courts of the different jurisdictions are in sharp conflict as to which law governs validity.¹⁶³ One view is that the entire transaction is void when any one of the component steps, either offer, acceptance or performance, is illegal where done. Another view is that a contract will be enforced unless performance is illegal under the law of the place of performance, which is held to be decisive of the legality of the entire transaction.

A number of earlier California cases contain loose general statements to the effect that securities offered for sale, or sold or issued by a foreign corporation in California without a permit are void. A careful examination of all such cases discloses, however, that the securities involved were actually issued or delivered in California, or that, in cases where no securities were issued and only the validity of executory contracts was involved, all the preliminary steps in the transaction took place in California.¹⁶⁴

¹⁶³ Note (1937) 51 HARV. L. REV. 155, in which it is stated that under conflict of law rules, the act of offer is usually given less weight than either performance or acceptance. This is not true under the Corporate Securities Act since acceptance is of no materiality. See also Note (1942) 31 CALIF. L. REV. 95.

¹⁶⁴ Pollak v. Staunton (1930) 210 Cal. 656, 293 Pac. 26, was one of the earliest cases to consider the problem. Shares sold by a Nevada corporation to a California resident, without a permit, were held void. All the offers were made in California and the acceptance took place in California, and the decision clearly is rested on the grounds that all steps in the transaction, including the issue and delivery of the securities, actually took place in California.

In the subsequent case of *Randall v. California Land Buyers' Syndicate* (1933)

In the first case presenting a factual situation where there had been preliminary transactions in California, but actual delivery outside the state, the ninth circuit court of appeals in 1931, in *Los Angeles Fisheries v. Crook*,¹⁶⁵ held that a contract for the purchase of stock, though initiated in California but consummated in Nevada and calling for delivery of the certificates for shares in Nevada, was not governed by the laws of the state of California. In that case the plaintiff, a resident of California, sought to purchase stock of the defendant corporation, a Delaware corporation with an office in Nevada and one in Los Angeles. The plaintiff attempted to pay the subscription price in Los Angeles but was informed that it would be necessary

217 Cal. 594, 20 P. (2d) 331, and its companion case of *Holmquist v. Kent* (1933) 219 Cal. 231, 25 P. (2d) 977, both involving sales of shares by the same Delaware corporation, it was held that shares sold by a Delaware corporation, qualified to do business in California, in violation of the terms of a permit obtained from the Commissioner of Corporations were void. Both these cases involved a corporation which had a commercial domicile in California, was doing all its business in California, and had actually obtained a permit in California but had sold its shares in California in violation of the terms of the permit.

In the case of *Schnierow v. Las Vegas L. & B. Co., Inc.* (1932) 124 Cal. App. 715, 13 P. (2d) 529, a sale of stock by a Nevada corporation without a permit was held to be void. Here, again, it is apparent that the opinion is rested on the grounds that the original issue actually took place in California.

Gillis v. Pan American Western Pet. Co., *supra* note 157, involved a corporation which, while incorporated under the laws of Delaware, clearly had a "commercial domicile" in California. Its principal place of business was in Los Angeles and it transacted all its business there, including the holding of its meetings of directors. On an appeal from a judgment based on a demurrer without leave to amend, the court held that stock issued by a foreign corporation in California without a permit is void. Here, again, it would appear clear that the decision is based on the grounds that all steps in the transaction, including the original issue, were taken in California.

The companion cases of *California Western Holding Co. v. Merrill* (1935) 7 Cal. App. (2d) 131, 46 P. (2d) 175, and *Los Angeles Transfer v. The Ritz Carlton Hotel Co.* (1935) 7 Cal. App. (2d) 154, 46 P. (2d) 186, involved the validity of preorganization subscription agreements for units of stock in two separate corporations, one of which was a California corporation designed to be a holding company and the other of which was a Delaware corporation designed to be the operating company, with its actual commercial domicile in California. The Corporate Securities Act as then in effect (section 25) permitted preorganization subscriptions only as to domestic corporations. [The present Act (section 33) permits preorganization agreements as to both foreign and domestic corporations.] Each of the foregoing cases held that preorganization subscriptions for stock of foreign corporations are void, and the former case held that "there is nothing unconstitutional in the right of the legislature to regulate the sale of securities of a foreign corporation in this State" (citing the *Gillis* case). In both cases the transactions halted short of the actual issue of securities, and the questions presented involved merely the validity of executory contracts, not the validity of the securities themselves. In both cases all steps in the transaction appear clearly to have occurred in California.

¹⁶⁵ (C.C.A. 9th, 1931) 47 F. (2d) 1031.

for him to send a letter addressed to Las Vegas, Nevada. The plaintiff signed such letter, which requested the Nevada office to issue stock in his name and send the certificates to a Nevada bank which then forwarded them to plaintiff in California. In an action to recover the purchase price on the grounds that the stock was void because issued without a permit from the California Corporation Commissioner, the court held that the contract was entered into in the state of Nevada and called for the delivery of the certificates to the bank in that state and was valid under Nevada law and was not governed by the laws of the state of California. The parties in this case clearly intended performance to take place outside the state; there was no fraud or misrepresentation present, but there was some evidence of an intention on the part of the seller to evade the California law.

In the subsequent case of *In re Motor Products Mfg. Corp.*¹⁶⁶ the ninth circuit court of appeals reaffirmed, in the main, its holding in the *Los Angeles Fisheries* case. The case arose in bankruptcy. The bankrupt, a Missouri corporation, operated in several states and acquired some property in Los Angeles. It entered into a contract in California agreeing to issue debentures to a resident in California, naming the California Trust Company, a California corporation, as trustee under the debenture indenture. The indenture was executed in California by the trustee and the debentures were authenticated by it there. However, the fully executed and authenticated debentures were delivered to a trust company in Missouri as agent for the resident of California who was to receive them. The court found that the issue actually took place in Missouri, that the debentures were valid under the laws of that state, and that the issue of the debentures in Missouri without a permit from the Commissioner of Corporations was not in violation of the California Corporate Securities Act. Hence, the debentures were valid claims in bankruptcy. There was no fraud or misrepresentation present, and the court further expressly found that the parties intended no evasion of California law.

The first reported opinion in the case of *In re Motor Products Mfg. Corp.* contains a somewhat involved interpretation of the California statute. The case was decided while the leading case of *Robbins v. Pacific Eastern Corporation*¹⁶⁷ was still pending in the California supreme court. Subsequent to the decision of the latter case—which does not even mention the case of *In re Motor Products Mfg.*

¹⁶⁶ (C.C.A. 9th, 1936) 85 F. (2d) 318 (first opinion).

¹⁶⁷ *Infra* note 170.

Corp.—the ninth circuit court of appeals, on a petition for rehearing, modified its previous opinion but reaffirmed its previous conclusion.¹⁶⁸ The court in so doing stated:

“The court decided this contention adversely to appellant upon a detailed study of the California Corporate Securities Act.

“Since that decision, the Supreme Court of California decided the case of *Robbins, et al., v. Pacific Eastern Corporation, et al.*, 65 P. (2d) 42. It was there held in no uncertain terms that a security transaction in New York, legal there, but which would require a permit if occurring in California, was not void for failure to obtain a California permit, even though the transactions leading up to the issue were held in California. In 65 P. (2d) 42, at pages 60, 61, it is said:

“ ‘As already indicated, even if it be assumed that the Corporate Securities Act did apply to the negotiations had in this state, and even if it be assumed that the executory contract, so far as the seller—the Trading Corporation—is concerned, was illegal, nevertheless, the performance and execution of the contract in New York being legal there, and being complete in themselves, stand independently of the prior illegality.’ This decision squarely sustains the holding of this court. The reasoning by which this court arrived at this conclusion, employing as it did an involved construction of the California statute, is no longer necessary. Construction of the act is properly the function of the state courts, not to be undertaken by this court except when necessary. It is no longer necessary in this case.”¹⁶⁹

The first case in the California supreme court which squarely presents the question whether securities *issued and delivered* in a foreign state are valid without a California permit when the preliminary transactions leading up to the issue took place in California and are illegal there, is the famous case of *Robbins v. Pacific Eastern Corporation*.¹⁷⁰ Since the case is of such far reaching importance it is believed that an extended discussion of it is justified. The case involved an exchange by Goldman Sachs Trading Corporation, a Delaware corporation (hereinafter in this discussion referred to as the “Seller”), of its shares with stockholders of American Company for shares held by them in the latter company which was a California corporation. Most of the latter’s stockholders, including some of the plaintiffs in the case, were residents of California. The offer came from the Seller and most of the preliminary negotiations were had in

¹⁶⁸ (C.C.A. 9th, 1936) 90 F. (2d) 8 (second opinion).

¹⁶⁹ *Ibid.* at 12.

¹⁷⁰ (1937) 8 Cal. (2d) 241, 65 P. (2d) 42.

California. The stockholders of American Company who were to make the exchange of their stock in that company deposited their stock with American Trust Company in California. The offer and acceptance called for delivery of the Seller's shares in New York. The actual exchange took place in New York by an agent of the Seller handing over its certificates to an agent of the American Trust Company who had come there for that purpose. The court held that the American Trust Company acted as agent for the stockholders of the American Company and that its acts were the acts of its principals. The plaintiffs contended that the preliminary negotiations conducted in California without the Seller having first obtained a permit were illegal and that the entire transaction was nonseverable and therefore the final delivery, even though made in New York where it would have been valid as a separate and independent transaction, was void because of the prior illegal dealings in California. The defendants contended that the Corporate Securities Act, properly interpreted, has no application at all to negotiations had in California that contemplate issuance and sale of stock by a foreign issuer in a foreign jurisdiction. The court reserved its judgment on this latter contention, but held that even if it be assumed that the negotiations in California were illegal, nevertheless, the validity of the sale in New York was not affected. The court rested its decision on the grounds that the contract clearly called for delivery of the securities in New York; even though the executory contract to sell was illegal, that would not prevent the parties from later making another legal contract in New York; the buyers (*i.e.*, stockholders of American Company) through their agent in New York, did complete the sale there, which, being valid there and complete in itself, stood independent of the prior illegality and thus was valid everywhere. Even though it be assumed that the offer made by the Seller in California was illegal, no action of the buyers in California was illegal. Since the Act is aimed at the seller and not at the buyer, the acceptance by the buyers of the offer in California was not tainted with illegality and the appointment of the agent in California by the buyers was legal. In consummating the sale in New York through their agent, the buyers entered into a valid sale, legal in New York and standing independent of the prior illegal executory contract to make it.

The court found that there was no fraud or misrepresentation present and that New York was not seized upon as the place of delivery as a subterfuge to evade the law of California.

The rule of the *Robbins* case has not been modified, limited or restricted by the California supreme court. It has, however, been expressly followed by other courts.¹⁷¹

It is a striking coincidence that the California supreme court and the ninth circuit court of appeals by unanimous decisions independently arrived at substantially the same conclusions at almost the same time. While it is of course axiomatic that the decisions of the ninth circuit court of appeals on questions of state law are in noway binding on the California courts, nevertheless, the two decisions of that court in the *Los Angeles Fisheries* case and the *Motor Products* case are persuasive in demonstrating the soundness of the conclusion arrived at by the California supreme court.

In none of the three cases was there any fraud. Moreover, there were express findings in both the *Robbins* case and the *Motor Products* case that there was no intent to evade the Corporate Securities Act.

The rule laid down by these three cases to the effect that the contract will be enforced unless performance is illegal by the law of the place of performance, even by the courts of the place where preliminary acts were taken and were there illegal, has been the subject of much discussion and some criticism.¹⁷²

The essence of the criticism is that the decisions open the door to evasion and render meaningless the portion of the Act which prohibits an issuer to "offer for sale, negotiate for sale of" any security of its own issue until it shall first have applied for and secured from the Commissioner a permit authorizing it so to do. The critics of the decision in the *Robbins* case—while all seemingly concede the justice of the result under the facts of the case—are fearful that it destroys all control or regulation over the preliminary acts of foreign

¹⁷¹ *Jones v. Re-Mine Oil Co.* (1941) 47 Cal. App. (2d) 832, 119 P. (2d) 219, Div. One, Second Dist. Ct. of Appeal; and by the second circuit court of appeals, in *Person v. The National City Company* (C.C.A. 2d, 1942) 129 F. (2d) 326, in addition to the *Motor Products* decision in the ninth circuit court of appeals, *supra* notes 166, 168. In all decisions of the district courts of appeal subsequent to the *Robbins* case, which have held securities issued by a foreign issuer without a permit to be void, it is clear that the decisions are rested on the ground that all transactions took place in California or that delivery actually occurred there. *Cf. Boteler v. Conway* (1937) 23 Cal. App. (2d) 35, 72 P. (2d) 208; *Parmely v. Boone* (1939) 35 Cal. App. (2d) 517, 96 P. (2d) 164.

¹⁷² *Notes* (1937) 51 HARV. L. REV. 155, (1938) 26 CALIF. L. REV. 265 (the writer of this note erroneously implies that the preliminary acts of offering or negotiating without a permit renders the securities void); (1938) 11 SO. CALIF. L. REV. 345; Brief of Edwin M. Daugherty, as Amicus Curiae, in support of Petition for Rehearing in case of *Motor Products Mfg. Corp.*, *supra* notes 166, 168.

corporations in California leading up to a sale of securities if there is an intent to make delivery in another state and such delivery is made in a state where legal and if such state has a reasonable relation to the executory contract. They fear that this rule may lead to widespread evasions of the Act and will permit fraudulent and unscrupulous promoters to form corporations in other states to sell their spurious securities in California. It is submitted that this criticism is wholly groundless.

If any one general rule emerges sharply and clearly from the confusion and fog of the bewildering mass of cases that have construed the Act, it is certainly the rule that fraud, exploitation, sham and any attempt to evade the Act can be effectively reached under any and all circumstances. The courts are as realistic and as intensely practical in this field as they are in the field of federal income tax. The situation in the *Robbins* case was vastly different from that in the sham and evasion cases discussed under a previous caption. Obviously, the rule of the *Robbins* case can be of no comfort to the "dishonest and unscrupulous promoter" who literally "hatches" a new foreign corporation overnight for the purpose of evasion of the Act. The rule of the *Robbins* case does not protect any spurious device. Even as limited by the *Robbins* rule, the Act casts a very broad net. Concededly, as under most police power measures, legitimate, honest business men must willingly submit to reasonable controls in order to effectuate the purpose of the legislation, but the controls should not be extended to wholly unnecessary, unreasonable or absurd lengths.

The court in the *Robbins* case assumed for the purposes of the decision that the preliminary act of the foreign issuer in making the offer in California was illegal. It reserved for future determination the important question whether, as contended by counsel for defendants, the Act, properly interpreted, has no application at all to negotiations had in California that contemplate the bona fide issuance of stock by a foreign issuer in a foreign jurisdiction. While the court reserved its decision on this point, it did not express its disapproval of this contention. There is much to be said in support of such a rule that the Act, properly interpreted, has no application at all to bona fide preliminary negotiations had in California that contemplate the issuance of securities by a foreign issuer in a foreign jurisdiction, *if there is a complete absence of fraud, sham, and an intent to evade the Act.*

At the very least, it would appear desirable to construe the Act in such manner, or if need be to amend it, so as not to outlaw bona fide interstate transactions between foreign issuers and their stockholders resident in California which are merely a part of a larger plan conducted on a nation-wide basis.

If the Act is to be literally interpreted and applied to interstate transactions between foreign issuers and their stockholders resident in California, there can be no doubt that over the past twenty years or more a countless number of the nation's great corporations have innocently and in good faith technically violated the Act by failing to obtain permits in direct issue transactions with their security holders resident in this state. Almost all of the large corporations of the country have California stockholders. Moreover, it is generally known that over the past twenty or twenty-five years such corporations have had innumerable diverse security transactions with stockholders involving split-ups, offerings of "rights", stock purchase warrants, conversions, exchanges in connection with both voluntary and compulsory statutory recapitalizations, and statutory mergers and consolidations. It is believed that the files of the Division of Corporations will reveal that such foreign issuers have in such instances applied for California permits only occasionally. It is believed that this is particularly true with respect to modifications and changes of outstanding securities, which under the extreme California theory constitute the issuance of new securities requiring a permit. It is almost certain that such California theory of modification would come as a surprise to practically all out-of-state lawyers, and strike them as being novel and mystifying. It is almost unthinkable—and certainly unnecessary to effectuate the main purpose of the Act, which is to prevent fraud and exploitation—that our courts would hold all such securities of foreign issuers which came into the hands of existing California stockholders, and most of which are undoubtedly still circulating here, to be void, because of such technical and innocent violation of the Act in failing to obtain permits for such transactions. It is equally inconceivable that the California authorities would ever attempt to enforce any of the criminal provisions of the Act in any such case against any of the participating officers of such issuers who might happen to be visiting or sojourning in California.

The problem of the foreign issuer under the Act is merely a segment of the much larger problem of burdensome duplication in the field of interstate securities distributions by reason of the conflicting

federal requirements and the widely diverse requirements of the various state securities acts. There can be no reasonable doubt that there is a crying need for a more reasonable correlation and harmonizing of federal and state requirements. There is already a vast amount of literature on the subject,¹⁷³ but very little improvement has been actually accomplished. Only a lawyer who has had the actual experience of qualifying a security issue in almost all of the forty-seven states which have some form of blue-sky law, concurrently with or immediately following registration under the Securities Act of 1933, has any real comprehension of the stupendous, tedious and wasteful task involved. It entails a vast amount of expensive duplicative work, most of which signifies nothing.

The Corporate Securities Act is an effective and vitally necessary complement to the federal acts in the field of intrastate distributions. It affords adequate investor protection with respect to all intrastate primary distributions of securities which are exempt from registration under federal requirements, and also with respect to new issues of California issuers which enter into interstate commerce, but are exempt from registration by reason of some exemption granted either by the Securities Act of 1933 or by the regulations thereunder. It is also an important supplement to the federal act in the case of some unsound, registered new money issues, since the federal act is merely a disclosure act and the Securities and Exchange Commission does not have the power to pass upon the quality of securities.

However, the Act is a serious and, it is believed, an unnecessary burden, in the case of most interstate security transactions between a foreign issuer and its existing security holders involving reorganizations and exchanges. Such transactions do not involve new money issues and it is clear that they do not have the remotest kinship to the sham or evasion cases heretofore discussed. In many cases only an insignificant fraction of such existing security holders are resident in California; and in many cases it never occurs to either such issuer or its counsel, no matter how learned, that a permit must be secured in California with respect to the securities proposed to be issued in modification transactions to residents of California.

It is submitted that California could make its slight contribution

¹⁷³ E.g., Smith, *State Blue Sky Laws and the Federal Securities Act* (1936) 34 MICH. L. REV. 1135; Smith, *The Relation of Federal and State Securities Laws* (1937) 4 LAW & CONTEMP. PROB. 241; Wright, *Correlation of State Blue Sky Laws and The Federal Securities Acts* (1941) 26 CORN. L. Q. 258. The National Association of Securities Commissioners has also published various reports on the subject, notably the Report of Committee on Coordination and Uniformity at its 20th annual convention.

to the problem of correlating and harmonizing the conflicting federal and state requirements, without in anywise opening the door to fraud, exploitation, sham or evasion, if a limited exemption were granted under the Act for bona fide interstate transactions between a foreign issuer and its existing security holders resident within this state involving "reorganizations".

Without any thought of finality of language, or any attempt to exactly conform to the existing terminology of the Act, it is suggested that the addition of a new paragraph 4 to subdivision (c) of section 2 of the Act—which exempts certain specified transactions from the provisions of the Act—would accomplish such purpose. Such new paragraph could be substantially as follows:

"4. Interstate transactions between a foreign issuer not having its commercial domicile within this state, and its existing security holders resident within this state, where such issuer has existing security holders resident in not less than ten states and all its existing security holders are accorded equal treatment according to their respective rights, preferences and holdings, and where no cash is paid or given by such security holders and no existing indebtedness owing to them is cancelled except in exchange for a substantially equivalent consideration, including, without limiting the generality of the foregoing, share dividends, conversions, and exchanges and modifications of bona fide outstanding securities. Solely for the purpose of this paragraph, in the case of statutory mergers and consolidations, all security holders of all constituent corporations shall be deemed to be existing security holders of such foreign issuer."

However, until the point is clarified either by the California supreme court or by appropriate legislative amendment, foreign issuers should avoid all preliminary negotiations in direct issue transactions with their security holders resident in California before a permit is obtained. The safest course in every such situation is for the issuer to obtain a preliminary offering permit even before submission of the plan to shareholders. This would legally permit the issuer to make the offering in California. As soon as the results of the acceptance by California resident shareholders were ascertained, it would then be necessary for such issuer to obtain a definitive issuance permit with respect to the maximum number of securities to be actually issued to its existing security holders resident in California.

ISSUES AND SALES IN VIOLATION OF PERMIT CONDITIONS

Since the time of its original adoption in 1917, the Act has contained, in section 4, power authorizing the Commissioner to impose

conditions governing the issue and sale of securities. The pertinent provision of section 4 of the present Act, which has remained unchanged since first incorporated in the Act in 1925, reads as follows:

"... The Commissioner may impose conditions requiring the deposit in escrow of securities, the impoundment of the proceeds from the sale thereof, limiting the expense in connection with the sale thereof and such other conditions as he may deem reasonable and necessary or advisable to insure disposition of the proceeds of such securities in the manner and for the purposes provided in such permit."¹⁷⁴

For many years the rules and regulations of the Commissioner of Corporations have contained elaborate provisions as to permit conditions governing the impoundment of the proceeds of sale, the escrow of shares, limitation of selling expenses, and other conditions on the issue of securities. The obvious purpose of such permit conditions is an endeavor to safeguard, at the outset, the soundness and quality of the securities to be issued. Permit conditions usually relate to terms of offer, sale, consideration and issue. Many of such conditions are clearly conditions precedent to or concurrent with the issue of the security.

The most usual types of conditions precedent or concurrent contained in permits are as follows:

(a) Conditions as to the kind of consideration to be given and the manner of payment, *e.g.*, the permit may require that shares be issued only for cash, or for property subject to specified indebtedness to be assumed, etc.;

(b) A condition requiring exhibition of the permit prior to sale or issuance of the security (not merely prior to delivery of the securities);

(c) Conditions both for the impoundment of the proceeds of sale and the escrow of shares. In these cases it is obvious that there is no completed, valid issue until the conditions are fully complied with. Title to the funds does not belong to the issuer nor is title to the shares vested in the purchaser until such conditions are met;

¹⁷⁴ The pertinent provision of the original Act read as follows: "Sec. 4. . . . The Commissioner may impose such conditions as he may deem necessary to the issue of such securities" Even in cases involving transactions prior to the 1925 amendment, the California courts had held that the Commissioner could require stock to be placed in escrow and impose other conditions. *Agnew v. Daugherty* (1922) 189 Cal. 446, 209 Pac. 34; *Otten v. Riesener Chocolate Co.* (1927) 82 Cal. App. 83, 254 Pac. 942. See also, *BALLANTINE, op. cit. supra* note 95, at 360, and cases there cited.

(d) A condition requiring the issuer to appoint a registrar and to cause the certificate to be registered before delivery;

(e) A condition limiting selling expense; and

(f) In the case of indenture securities, a condition requiring the prior execution of the indenture, and, if secured obligations are involved, requiring the due recordation of the indenture.

All of the foregoing are clearly conditions precedent to or concurrent with the valid issue of the securities.

The only conditions ordinarily inserted in permits which are clearly *conditions subsequent* to the issue of securities are those limiting salaries, dispositions of proceeds, etc., the condition requiring the issuer to maintain a transfer agent, and the condition requiring an "escrow" of the shares not coupled with any impoundment of the proceeds. The last type of condition is contained only in so-called "closed permits", that is, permits to issue securities in private transactions in which the original subscribers or stockholders are specifically named and no general public offering is involved.¹⁷⁵ Such condition requiring the "escrowing" of the shares is imposed both on the issuer and the original subscribers or purchasers of the shares to prevent sales or transfers of such shares to the public until such time as the issuer has a demonstrated earning power. Usually in such cases the securities are highly speculative, or the escrowed shares have been issued for services or intangibles and are made nonwithdrawable until investors who have paid cash have been reimbursed or otherwise adequately protected, but in the pure "escrow" condition the Commissioner does not require any impoundment of the considerations given for the shares. Many of such cases involve transactions whereby the promoters actually convey the full consideration for the shares to the issuer, usually consisting of mining claims, patents, or other property of a speculative nature and an unseasoned income-producing power. As between the issuer and the promoter-subscribers, the transaction is complete; the subscribers have conveyed to the corporation full consideration for the issue of the shares and title to the properties furnishing the consideration is actually vested in the corporation and title to the shares actually passes to the promoter-subscribers.

For many years there was great uncertainty in the California de-

¹⁷⁵ See *Domestic & Foreign Pet. Co. v. Long*, *supra* note 71, at 557, 51 P. (2d) at 77, wherein the court states: "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."

cisions as to the exact legal effect of nonconformance with the conditions of a permit. It is now well established that any security issued in violation of the terms of a permit is void.¹⁷⁶ It would appear equally clear that any violation of any condition precedent to or concurrent with the original issue of new securities would constitute a violation in the issue of the securities and render the security void. On the other hand, violations of conditions subsequent contained in a permit, such as a condition limiting salaries, or a pure "escrow" condition, do not render the security void. In such cases, the securities are validly issued and outstanding and, although any *sale* thereof in violation of such a condition would be illegal, the security itself would not be void.¹⁷⁷ This matter is hereinafter more fully discussed in connection with the legislative history of the express sanctions contained in the Act.

¹⁷⁶ *Regan v. Albin* (1933) 219 Cal. 357, 26 P. (2d) 475; *Kahle v. Stephens* (1931) 214 Cal. 89, 4 P. (2d) 145. This is probably not true as to securities issued between 1931 and 1933 while the 1931 amendment to the Act was in effect.

¹⁷⁷ *Duntley v. Kagarise* (1935) 10 Cal. App. (2d) 394, 52 P. (2d) 560.