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California Corporate Securities Law
Of 1968: Some Interpretations,
Some Problem Areas

WILLIAM R. BICKFORD*

The California Corporate Securities Act of 1968 was a significant and innovative extension of State power over the general area of securities transactions. In the few years since its enactment it is evident that prudent application of the Act to legal problems requires a comprehensive understanding of certain key provisions. The author’s contribution is intended to provide enlightenment regarding the interrelationship of the significant sections of the Act as they have been interpreted and applied in practice. This expertise is, in part, derived from many years of experience in the positions of Corporations Counsel for the State Department of Corporations. In this article the author focuses his attention on jurisdictional problems regarding the sale of securities, nonpublic and exempt transactions, "secondary trades," options which constitute sales, and liabilities for violation of the Act.

California’s new Corporate Securities Law of 1968 became effective on January 2, 1969.1 Although the law has received wide publicity, there have been some legislative as well as rule changes and interpre-

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tations of the law by the Commissioner which have not been as widely publicized. Some problem areas under the prior law continue to present problems to the practicing attorney and certain areas of the new law may offer pitfalls to the attorney who is not sufficiently familiar with the entire regulatory scheme or with specialized aspects of securities law. The purpose of this article is to discuss some of the more significant of these changes and interpretations and to discuss and offer clarification of certain of the problem areas.

Outline of New Law Changes

The Corporate Securities Law of 1968 represents a major modernization of the prior regulatory scheme shifting emphasis from areas which experience shows require less regulation to those in which the prior law did not provide adequate remedies or regulation. A major change in the law is the addition of specific provisions relating to the jurisdictional application of the statute. Also several new and significant exemptions are created for certain securities and transactions which either because of regulation by other agencies or because of limited danger to the public do not warrant regulation. The most important exemptions are those for securities traded on the New York Stock Exchange and the small offering or close-corporation exemption. Non-issuer transactions or "secondary trading" are, however, for the first time subjected to regulation in California. The law adds detailed provisions respecting civil liabilities and creates new statutory liabilities. In addition, the Commissioner is given new authority to bring civil actions on behalf of investors in certain circumstances.

The new law contains three qualification sections instead of one as under the prior law. This distinction recognizes the conceptual differences in these transactions. Direct issuer transactions are qualified

referred to herein as either the "new law" or the "1968 law." The 1917 law will be referred to as the "prior law" or "prior statute."

2. The philosophical basis of the new law as well as the major changes in California securities law effected by this legislation are discussed in Chapter One of the text, H. MARCH AND R. VOLK, PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968 (1969) [cited hereinafter as MARSH & VOLK]. This text, to which frequent reference is made in this article, also provides a comprehensive and detailed analysis of the new law as well as a comparison of provisions of the prior law and is an excellent practice handbook. It is evident from the Draftsmen's Commentary to the 1968 law which is published in Appendix A of MARSH & VOLK that the new law is drawn from the Uniform Securities Act and the federal securities laws as well as from the prior law.

3. CAL. CORP. CODE § 25008.
4. CAL. CORP. CODE §§ 25100(o), 25102(h).
5. Id.
6. CAL. CORP. CODE § 25130.
7. CAL. CORP. CODE §§ 25400-25510.
8. CAL. CORP. CODE §§ 25530, 25531.
9. CAL. CORP. CODE §§ 25110, 25120, 25130.
under section 25110, recapitalizations and reorganizations under section 25120 and nonissuer transactions under section 25130. There are also three different methods of qualification for issuer transactions subject to section 25110: coordination, notification and permit. Coordination and notification are shortened procedures applicable to certain transactions where substantial information has already been filed under the federal statutes. The "fair, just and equitable" standard has been retained in the new law; however, in respect to qualification by coordination and notification the burden is shifted to the Commissioner to find the transaction is not "fair, just and equitable."11

Another significant new provision is section 25700 which provides, in part, that no provision of the law imposing any liability applies to any act done or omitted in good faith in conformity with any written interpretive opinion of the Commissioner. Section 25618 provides that the Commissioner in his discretion may honor requests from any interested person for interpretive opinions.

Jurisdiction—"In this State"

The prior law at section 25500 provided that,

No company shall sell any security of its own issue, . . . or offer for sale, negotiate for the sale of, or take subscriptions for any such security, until it has first applied for and secured from the commissioner a permit authorizing it so to do.12

The civil liability sections of that law provided at section 26100 that,

Every security of its own issue sold or issued by any company without a permit of the commissioner then in effect authorizing the issuance or sale of the security is void.13

Section 25003 defined "company" to include,
All domestic and foreign private corporations, associations, syndicates, joint stock companies, and partnerships of every kind.\textsuperscript{14} Thus it was clear that the statute was intended to apply to out-of-state issuers. These sections, in combination with certain other provisions of the statute, produced some anomalous results. Since the statute voided every security “issued” by a company without a permit, it was necessary that a company incorporated in California obtain a permit to sell securities to nonresidents of California even though the corporation may not have had an office or any place of business in this state and although the offer, acceptance and delivery—everything except the “issuance”—took place outside California. Likewise a permit was required before a California corporation could “issue” a share dividend, although a permit was not required to authorize a foreign corporation to issue a share dividend to its California shareholders.\textsuperscript{15} And since section 25009(a)\textsuperscript{16} defined a sale to include “any change in the rights, preferences, privileges, or restrictions on outstanding securities, . . .” foreign corporations were required to obtain a permit to solicit California shareholders whenever the solicitation would affect the rights of that class of stock. For example, a permit was required when the solicitation was to authorize an amendment to articles creating a new class of stock with a dividend or asset preference.\textsuperscript{17}

On the other hand, since section 25500 did not expressly apply to a sale by an underwriter as well as the issuer,\textsuperscript{18} it was concluded that a permit was not required to authorize the public distribution of securities in California by underwriters who had made a firm commitment with the issuer outside California to underwrite the entire issue. The rationale supporting this conclusion: the sale “by the issuer” had taken place outside California and the underwriter was merely reselling out-

\begin{footnotesize}
\begin{enumerate}
\item[14.] CAL. STATS. 1949, c. 384, § 1, p. 698, repealed, CAL. STATS. 1968, c. 88, § 1, p. 243.
\item[15.] In an opinion interpreting provisions of the California Insurance Code which were “practically identical” to provisions of the Corporate Securities Law when enacted, the Attorney General of California said that a permit under the Insurance Code was not required for a stock dividend of a foreign insurer where the only act which occurs in the State of California in connection with this transaction is the delivery of the certificates by United States mail to such of its shareholders as are residents of California. 17 OP. CAL. ATT’Y GEN. 217, 222 (1951).
\item[16.] CAL. STATS. 1949, c. 384, § 1, p. 689, as amended, CAL. STATS. 1949, c. 388, § 1, p. 729.
\item[17.] See MARSH & VOLK, supra note 2, at 11. See also 36 OP. CAL. ATT’Y GEN. 12. (1960) where section 25009(a) was interpreted to require a permit for even technical changes where, for instance, by amendment to articles par value stock is changed to no par stock without any change to stated capital. However, certain of those purely technical changes were exempted from the requirement of a permit by a 1961 amendment to former section 25500. CAL. STATS. 1961, c. 1574, § 1, p. 3398.
\item[18.] CAL. STATS. 1917, c. 532, § 3, p. 675, as amended, CAL. STATS. 1931, c. 423, § 2, p. 941.
\end{enumerate}
\end{footnotesize}
standing securities in this state.\textsuperscript{19}

It appeared clear enough that the statute applied to offers and sales made directly by foreign issuers to residents of this state (not through underwriters who had purchased outside California). A review of the cases under the prior law, however, reflects that the California courts did not consider the statute so clear in respect to the question whether the transaction was voidable by the buyer when some part of the sale was concluded outside of this state. A leading case is Robbins v. Pacific Eastern Corporation,\textsuperscript{20} decided by the California Supreme Court in 1937. In that case one McKee, a director and shareholder of the American Company (American), a California corporation, initiated negotiations in California with Taylor, a representative of a Delaware corporation, Goldman Sachs Trading Corporation (Goldman Sachs), with principal offices in New York, for an exchange of his shares of American for shares of Goldman Sachs. Goldman Sachs was only interested in an exchange if it could acquire a majority of the outstanding stock of American. Ensuing negotiations ultimately led to an offer from Goldman Sachs addressed to the "shareholders" of American communicated to them by letter from McKee. The offer contemplated that the American shareholders, substantially all of whom resided in California, would deposit their shares with a California depositary (American Trust Company, an affiliate of American). After a majority of the American shares had been deposited with American Trust Company in California, McKee pointed out to Goldman Sachs that delivery of Goldman Sachs certificates to the California depositary might result in a sale here requiring a permit. Consequently it was agreed that an officer of American would hand carry the certificates for American shares to New York for the physical exchange (later changed to New Jersey to avoid New York transfer taxes). The Goldman Sachs shares, however, were delivered in New York. In its opinion the court assumed that the offer by Goldman Sachs was made in California and accepted here. It also assumed that the Corporate Securities Act provisions in effect at that time applied to negotiations or offers by a foreign corporation made in this state, and that the executory contract formed by offer and acceptance in California was illegal. However, the court also found that a proper interpretation of the agreement indicated that the parties intended that title was to pass upon delivery of the Goldman Sachs shares. The court determined that delivery was in New York, and since such

\textsuperscript{19} This was the conclusion of the Attorney General in an unpublished opinion to the Commissioner dated July 15, 1940, Op. CAL. AT'Y GEN. 2780 (1940), on file at the Commissioner's office.

\textsuperscript{20} 8 Cal. 2d 241 (1937).
contracts were legal there, the contract was legal where performed. The court concluded that performance of the contract in New York stood independently of the prior illegality.21

Professor Louis Loss, in a detailed discussion of conflict of laws problems in Blue Sky Laws, pointed out in a 1957 Harvard Law Review article22 that the situation in Robbins has been substantially repeated in several other cases involving the California Act. He noted, however, that these holdings could not be divorced from the language of the California statute which at that time applied only if a security was “issued” without a permit or in contravention of the terms of a permit.23 According to Loss, the California cases “. . . seem almost always, but not quite, to equate the ‘issue’ of shares by a foreign corporation outside of California with their delivery.”24 Loss suggested that the result may be different, however, after the California courts had an opportunity to construe the 1947 amendment to the California statute, making void any security “sold or issued” without a permit.25

Attorneys for plaintiff, a California resident, urged this proposition in a recent case involving the application of the prior California statute to an interstate transaction. The case, Robinson v. Cupples Container Co.26 decided in September 1970, by the United States District Court, Northern District of California, was before the court on motions by defendants to dismiss on grounds that the amended complaint failed to state a claim upon which relief could be granted. Although the court’s opinion did not provide a detailed statement of the transaction relating to the sale of securities, the court stated that, “. . . it is undisputed that, although negotiations leading to the contract occurred in California, the contract itself was performed and executed and the securities were transferred in Clayton, Missouri.”27 Plaintiff argued that the Robbins case dealt with the California Securities Law as it existed prior to 1947 (voiding every security “issued” by any company without a permit)28 and that the case was overruled by the 1947 amendment to section 26100 which as amended provided that every security “sold or issued” without a permit is void.29 Plaintiffs also pointed out that the prior law,
in effect at the time of the Robbins decision, defined “sale” to include any offer, attempt to sell or solicitation to sell within California.

The court rejected this argument, agreeing with defendants that the 1947 amendment was intended to make it clear a corporation could not resell treasury shares without obtaining a permit (a resale of such outstanding shares arguably not constituting an “issue”). The court distinguished the case of Ogier v. Pacific Oil & Gas Development Corp. on the rationale that the transaction at issue in that case was wholly intrastate while in Robbins the activity involved the transactions beyond the jurisdiction of the state. It concluded that the “place of performance of an executory contract for the sale of securities is all important and that Robbins is still the law.”

The 1968 law will effect changes in each of the results noted above. The voiding provision has been eliminated entirely and liability will result from the offer or sale without qualification with no reference to issue. Therefore, qualification is no longer required where the only contact with this state is corporate domicile. If securities of a California corporation are offered and sold outside of California to nonresidents, a permit is not required solely because of technical issuance in California. This will bring relief in the situation where a foreign corporation or nonresident individuals acquire all of the stock of a California corporation and move its office from California to the foreign state. In the past a permit was required even if offers and sales were made from the corporation’s offices in the foreign state to residents of that state. Section 25008(b) now provides that an offer is made in this state and is subject to the permit requirement only if it originates from this state, or is directed to, and received in this state. So, if in fact an offer is sent from California, even though to a nonresident, qualification is required unless some exemption is applicable.

The issuer qualification sections of the new law, sections 25110 and 25120, require qualification whether an offer or sale is directly by the issuer or “by or through underwriters.” Securities sold in this state by underwriters are thus subject to qualification even though technically the “sale” by the issuer occurs outside of California. California corporations are no longer required to obtain a permit to “issue” a share dividend as the statute no longer applies to an issuance which is not also a sale and section 25019 excludes the ordinary share dividend from

31. 316 F. Supp. at 1368.
32. Former section 26100, which contained the voiding provision, was repealed by CAL. STATS. 1968, c. 88, § 1, p. 243. It was not replaced. CAL. CORP. CODE §§25110, 25120, and 25130 now govern liability for unqualified issues.
33. See notes 12-14 supra and accompanying text.
the definition of sale. Although the new statute also defines sale to include a change in rights, preferences and privileges on outstanding shares, the burden on the foreign corporation with only a few shareholders in this state is relieved by limiting the changes on outstanding shares which require qualification to only those changes specified in section 25103(e); and then only if the change will substantially and adversely affect any class of shareholders; and finally such changes are exempt unless the holders of at least 25 percent of the outstanding shares of any class affected have addresses in this state according to the corporation records.

Would the decision in the Robbins case be the same under the new law? It appears not. The new law for the first time includes express provisions relating to jurisdiction. The basic qualification sections of the new law require qualification for offers and sales “in this state” and this phrase is incorporated into the civil liability provisions by reference. Section 25008 sets forth a detailed definition of the phrase, “in this state” providing in subsection (a) that an offer or sale is made in this state when (1) an offer to sell is made in this state or (2) an offer to buy is accepted in this state or (3) (if both the seller and the purchaser are domiciled in this state) the security is delivered to the purchaser in this state. Subsection (b) provides that an offer to sell (or to buy) is made in this state when the offer either originates from this state or is directed by the offeror to this state and received at the place to which it is directed.

The statute as applied in Robbins, however, defined “sale” to include an offer to sell or a solicitation of a sale and the court conceded that both an offer and acceptance, an executory contract, had been made in California. The court did not expressly say it was looking for the place of “issue” and the federal district court in the Robinson case suggests that the “issue” language in the prior law was not the determinative factor in these cases. On its face the Robbins opinion suggests that the decision rests on the proposition that an entirely separate and new sale was made outside of California. The court quoted with approval the earlier state court holding in Moore v. Moffatt that the validity of a sale when made is not affected by a prior illegal contract to make such a sale.

34. CAL. CORP. CODE § 25017(a).
35. CAL. CORP. CODE § 25103(b)(c)(d).
36. CAL. CORP. CODE §§ 25110, 25120, 25130, 25503.
37. CAL. STATS. 1917, c. 532, § 7, p. 674, as amended, CAL. STATS. 1929, c. 707, § 1, p. 1251.
38. 316 F. Supp. at 1367-1368.
39. 188 Cal. 1 (1922).
40. 8 Cal. 2d at 282.
Moffatt involved the sale and issuance of shares pursuant to a permit which was obtained after the parties had entered into an illegal subscription agreement. That state court concluded that although the parties could not "ratify" the prior invalid agreement, by adopting and accepting the prior agreement after the permit was issued they had in effect "embodied" it in a new agreement effected by the sale and issuance of shares after the permit was obtained. In Robbins the court likewise found that a new agreement was effected by "performance and execution" of the contract by delivery in New York. The Robbins court was apparently very troubled by the fact that it could find no fraud or imposition by the sellers and that the buyers, apparently because of a market decline, had merely made a bad bargain.

Could a court faced with a similar factual problem reach the same conclusion under the new law despite its express provisions relating to jurisdiction? The explicit language of the new law would seem to preclude such a result. The Moffatt case reveals no facts to show a new agreement and it appears that the court created a fiction to fit the circumstances—not so objectionable perhaps in cases where in fact a permit is obtained. Likewise, the court in Robbins does not mention facts which would demonstrate that the parties concluded a new agreement in New York. The facts given warrant the conclusion that delivery in that state was merely performance in accordance with the terms of the initial agreement in California. It appears that the court by its characterization of the transaction in terms of contract performance in effect "transported" the sale to New York.

Section 25008 of the new law defines the "locus" of sale, not in terms of place of performance or delivery (unless both parties are domiciled in California) but place of offer. Since offer is defined in the securities law sense and not in terms of contract law the ultimate factor is place of solicitation. Therefore, the seller cannot manipulate the place of offer by conditioning the offer or soliciting from the buyer an offer to buy which must be accepted in the seller's state. This approach best serves

41. 188 Cal. at 6-7.
42. Section 25017(b) defines "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy (a security)." However, in what appears to be the first case relating to the jurisdiction provisions of the Uniform Securities Act, a federal district court in Oklahoma refused to apply the securities law of California even though the plaintiffs were solicited for sale in California. The facts indicated that the offer originated in Oklahoma and was directed to the buyers in California so that under the Oklahoma statute (which includes a provision substantially similar to section 414 of the Uniform Securities Act) the law of both states should have applied. The oil interests sold were not defined as securities under the Oklahoma statute, however, and the court, without discussing the jurisdiction sections of the Oklahoma statute, decided that this indicated a strong public policy of the state of Oklahoma that sellers of these interests were not to be subject to securities regulation. See Gaillard v. Field, 381 F.2d 25 (D.C. Okla. 1967), cert. denied, 389 U.S. 1044 (1968).
the public policy underlying the California securities law, to protect
the buyer or investor in the purchase of securities. The holding in
Robbins and cases which have followed it would encourage sellers to
substitute their own standards for those provided by the securities law.
The California securities law, however, offers more than protection
against fraud. In some cases, for example, the detailed financial disc-
losure required upon qualification may forewarn the buyer of an ulti-
mate decline in the market value of the seller's stock.

It is also significant that the court in Robbins considered that ac-
ceptance of the buyer's argument would place sellers in a dilemma.
The court said,

(Appellant's argument) would lead to the conclusion that when-
ever a foreign corporation desired to sell some of its stock to Cali-
fornia residents, and, in California, through one of its representa-
tives, entered into negotiations looking toward such object, assum-
ing such negotiations to be illegal, it could never legally complete
the deal, either in this state after it secured a permit, or elsewhere
without one.43

The new law removes this impediment by expressly providing in section
25503, governing civil liability that,

No person shall be liable under this section if the sale of the se-
curity is qualified prior to the payment or receipt of any part of
the consideration for the security sold, even though an offer to sell
or a contract of sale may have been made or entered into without
qualification.44

Professor Loss has noted that the holding in Robbins has been distin-
guished in a number of California cases where the facts show an overt
attempt to evade California law.45 It would appear that modernly the
need to resort to finding evasion would be eliminated by the express
provisions in section 25008 dealing with jurisdiction. The court in
Robbins said the result would have been obvious if the buyers had them-
selves gone to New York to complete the deal. Can the California law
be circumvented by soliciting the buyers to travel to Nevada to complete
a sale? Marsh and Volk note that the definition of offer in subdivision
(b) of section 20517 which includes any attempt to dispose of (or so-
licitation of an offer to buy) a security was intended to and will preclude
any evasion of the qualification requirements of the statute by the act
of the seller in inducing the buyer's to leave the state to complete the
sale.46 Therefore, any discussions regarding the proposed transac-

43. 8 Cal. 2d at 278.
45. Loss, supra note 22, at 236.
tion which may have progressed to the point where the parties are ready to travel in Nevada for the purpose of consummating the transaction will almost inevitably have involved an offer in this state.

Of course, it is also clear that a promoter cannot avoid application of the California statute by making sales in Nevada to persons solicited pursuant to the exemption in section 25102(a) regarding offers not made to the public. The nonpublic offering exemption of section 25102(a) merely postpones the time for qualification and does not affect jurisdiction so that the sale, wherever concluded, is “in this state” if the offer is directed to this state or originates from this state even though exempt from qualification at that point. This is obvious but may be overlooked by one predisposed to find an exemption for his client.

**Exemptions—Commercial Paper**

Certain exemptions from the requirement of qualification are added by the new law and others which are carried over from the prior statute are significantly modified. Since a detailed discussion of each of these changes is beyond the scope of this article, consideration will be limited to one of the new sections which apparently has not been clearly understood, and to the close-corporation exemption which is treated in the next section.

Section 25100(1) of the new law provides an exemption from qualification under either section 25110, 25120 or 25130 for

Any note, draft, bill of exchange, or banker’s acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace. . . .

This section, like its counterpart in the Uniform Securities Act, is based upon and is substantially similar to section 3(a)(3) of the Federal Securities Act of 1933. A clause has been added to the California version, however, which excepts from the exemption “. . . such promissory notes offered to the public in amounts of less than five thousand dollars ($5,000) in the aggregate to any one purchaser.”

The Securities and Exchange Commission (SEC) interpreted the federal exemption for “commercial paper” in a 1961 opinion. The

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47. Uniform Securities Act § 402(a)(10).

507
SEC discussed the legislative history of section 3(a)(3), the federal exemption clause, and noted that the House Report on the Act (Securities Act of 1933) stated: "Paragraph (3) exempts short term paper of the type available for discount at a Federal Reserve bank and of a type which is rarely bought by private investors." The SEC report concludes that the legislative history of the Act makes clear that section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks.

Also, the opinion interprets the nine-month maturity requirement as prohibiting obligations payable on demand as well as obligations with provisions for automatic "roll over." In this same opinion the SEC refers to Regulation A of the Board of Governors of the Federal Reserve System which governs advances and discounts by Federal Reserve banks. Subsection (a) of section 3 of this regulation provides that the paper, to be acceptable for discount, must not be a note, draft, or bill of exchange the proceeds of which have been used, or are to be used for permanent or fixed improvements of any kind, such as land, buildings or machinery, or for any other fixed capital purpose. The SEC has added that the exemption is not allowed where the proceeds are to be used for the discharge of existing indebtedness, unless such indebtedness is itself exempt under section 3(a)(3); for the purchase or construction of a plant, durable machinery or equipment; the funding of commercial real estate development or financing; the purchase of real estate mortgages or other securities; the financing of mobile homes or home improvements; or the purchase or establishment of a business enterprise. The California Commissioner of Corporations has also interpreted section 25100(l) as being applicable only to prime quality negotiable commercial paper available for discount by a Federal Reserve bank and has advised in an interpretative opinion that the exemption is not available for the sale of nontransferable notes as such paper would not meet the requirement of negotiability. Since the California section is substantially identical to the federal, the interpretation by the Securities and Exchange Commission should at least be of some weight.

51. Id. at 2556.
52. Id. at 2555.
53. Id. at 2556.
54. 12 CFR § 201.3(a)(2).
in future interpretations of section 25100(l) either by a court or the Commissioner.

The Securities and Exchange Commission notes that what is a current transaction is a question of fact to be considered in light of the particular facts and business practices surrounding individual cases. The SEC indicates that a type of paper which would fall within the terms of section 3(a)(3) is a short-term paper issued by finance companies to carry their installment loans. Professor Loss points out that some of the large finance companies do offer nine-month paper to the public from time to time in reliance on section 3(a)(3) of the Federal Act. It would appear in fact that the requirement that the paper be "prime quality negotiable commercial paper eligible for discount by a Federal Reserve bank" would limit its availability to very substantial, well-capitalized companies. It also seems clear that a financial worth test must be read into this exemption. Section 4 of Regulation A of the Board of Governors of the Federal Reserve Board, which relates to the general requirements for advances and discounts, provides in subsection (b) that in order to determine whether paper offered for discount is eligible and acceptable, any Federal Reserve bank may require that adequate statements be filed with it statements which adequately reflect the financial worth of one or more parties to any note, draft or bill of exchange offered for discount and of any corporations or firms affiliated with or subsidiary to such party or parties.

Even though an offer or sale of notes may be found to be exempt from qualification in California under section 25100(l) it should be noted that such sales are not exempt from sections 25401 and 25402. These latter sections provide for civil liability and criminal penalties for misrepresentation in connection with the purchase or sale of a security. The Commissioner's rules for determining whether a sale of debt securities to the public would be fair may be helpful in considering whether a transaction, even though not subject to the requirement of qualification, may be unfair or involve misrepresentations. The Commissioner's rule 140.9 would ordinarily prohibit the sale by a nonseasoned company of nonconvertible debt securities to the public. The philosophy underlying this rule is that it would be a misrepresentation for a new
company without an earnings history to promise that it can meet a fixed interest payment or in fact even repay principal. Also, Rule 140.10, relating to capital structure of seasoned corporations, provides that a seasoned corporation proposing to sell senior securities which are nonparticipating and nonconvertible must show its ability to meet the proposed dividend, interest and sinking fund requirements on all of its senior securities outstanding and proposed to be issued based upon its previous earnings or cash flow history or upon its demonstrated future earning or cash flow capacity. This rule is also based upon the proposition that it would be unfair and in fact may involve a misrepresentation to sell a debt security promising a fixed rate of interest where the issuer does not have a sufficient earnings record to demonstrate ability to meet the payments of both interest and principal. These rules, of course, provide only minimum standards and do not attempt to cover the question of the nature of the disclosure which may be required in a particular case.

Promissory notes or commercial paper, to meet the requirements of the exemption in section 25100(l), must be short term. Therefore, because of the very nature of the note that is subject to the exemption, it may be difficult for a relatively small company, even though seasoned, to show its ability to repay the obligation when due in nine months. It appears clear that the exemption provided by section 25100(l) is intended for those substantial companies which have adequate capital or established sources of capital to refund the indebtedness created by their issue. An example would be those finance companies whose securities are traded in the market, which regularly sell securities on the public market and which would therefore have a somewhat reliable source of new capital. In any event, it should be evident that the exemption is very limited and counsel should obtain an interpretive opinion from the Commissioner if there is any doubt that the securities to be sold are not clearly within the express terms and the intent of the section. Furthermore, even if it is determined that the exemption applies and that qualification is not required, the problem of misrepresentation and liability under sections 25401 and 25402 cannot be overlooked.

The Close-Corporation Exemption

The close-corporation or "small issue" exemption created by section 25102(h) of the new law will have the greatest impact in terms of num-

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Cal. Admin. Code, Title 10, § 260.001(f). The Commissioner's regulations relating to the Corporate Securities Law are preceded by the number 260. For convenience only the rule numbers following the 260 prefix will be cited and all references to the rules will be to Title 10 of the California Administrative Code.
bers of issues exempted. Securities laws of most states provide some form of "small issue" or "limited offering" exemption; however, the California provision is the most restrictive.\(^60\) In the first place, the California exemption applies only to the offer or sale of voting common stock by a California corporation. Second, it must be clear that immediately after the sale and issuance there will be only one class of stock of such corporation outstanding which is owned beneficially by no more than five persons. As do the statutes in a number of other states, the section prohibits the publication of any advertising or the payment or incurring of any selling expense or promotional consideration in connection with the offer, sale or issuance of the stock.\(^61\) Thus although the number of offers is not limited, the section precludes an offering to the public by use of advertisement and the ultimate sale can be made to only five persons, or in theory, as many as ten persons when spouses are included since shares held by a husband and wife are considered as held by one.\(^62\)

There are three additional requirements framed with the intent of limiting this exemption to those transactions which do not, on balance, warrant the application of the regulatory provisions of the Corporate Securities Law. Possibly the most significant is subsection (3) of section 25103 which limits the consideration for which shares may be issued under the exemption to:

(i) only assets (which may include cash) of an existing business enterprise transferred to the issuer upon its initial organization, of which all of the persons who are to receive the stock to be issued pursuant to this exemption were owners during, and such enterprise was operated for, a period of not less than one year immediately preceding the proposed issuance, and the ownership of such enterprise immediately prior to such proposed issuance was in the same proportions as the shares of stock are to be issued, or (ii) only cash or cancellation of indebtedness for money borrowed or both upon the initial organization of the issuer, provided all such stock is issued for the same price per share, or (iii) only cash, provided the sale is approved in writing by each of the existing shareholders and the purchaser or purchasers are existing shareholders, or (iv) in a case where after the proposed issuance there will be only one owner of the stock of the issuer, any legal consideration.\(^63\)

By so restricting the nature of the consideration, the draftsmen attempted to insure that the price paid by each shareholder would be


\(^{61}\) Id. at 2634-2641.

\(^{62}\) See CAL Corp. Code § 25102(h)(5).

\(^{63}\) CAL Corp. Code § 25102(h)(3).
equal and that there would be no dilution of the interests of shareholders. Once a corporation has issued shares, whether pursuant to a permit or to this exemption, it cannot utilize the exemption to sell shares to new investors even though after the sale the shareholders will not exceed five. Also, if shares are already owned by more than one person, the exemption can only be used to sell shares for cash to the existing shareholders.

Secondly, subsection (5)\(^64\) requires that there be filed or mailed for filing with the Commissioner not later than the day on which the securities are issued, a notice on a form prescribed by the Commissioner which contains specified information including an opinion signed by an active member of the State Bar of California to the effect that, on the basis of the facts stated in the notice, it is his opinion that the exemption is available for the proposed offer and sale of securities. As Marsh and Volk point out,

The theory behind this requirement of an opinion of counsel was that the involvement of an attorney in the transaction would not only tend to avoid the abuse of the exemption by persons who deliberately attempt to claim it when it is inapplicable, but also would reduce the possibility of the forfeiture of the exemption by an accidental failure to meet all of the conditions. . . .\(^65\)

Last, but definitely not the least significant of the restrictions on the availability of this exemption, is the requirement set forth in subsection (1) of section 25102(h) that:

All such stock shall be evidenced by certificates which shall have stamped or printed prominently on their face a legend in a form to be prescribed by rule of the commissioner restricting transfer of such stock in such manner as the rule provides.

The rule adopted pursuant to this subsection is 102.6,\(^66\) which requires that the shares issued pursuant to this exemption include the same restrictions on transfer as imposed by the Commissioner in respect to qualifications for the sale of securities to a limited class where an open sale to the public cannot be found to be fair, just and equitable.

Has section 25102(h) or its implementing rules been changed or interpreted so as to substantially broaden or limit its application? Only one of the technical amendments to the Corporate Securities Law of 1968 enacted by the legislature in 1969 and 1970 related to section 25102(h) and the change made was nonsubstantive.\(^67\)

\(^{64}\) CAL. CORP. CODE § 25102(h)(5).
\(^{65}\) MARSH & VOLK at 119.
\(^{66}\) Rule 102.6.
\(^{67}\) CAL. STATS. 1970, c. 612, § 2, p. 1192, amending CAL. CORP. CODE § 25102
Several rules promulgated upon enactment apply to section 25102(h). However, the only rule passed subsequent to the enactment of the law having a direct affect on the section is Rule 102.5, providing that for the purposes of section 25102(h) securities held by a partnership or joint venture shall be considered to be owned beneficially by each of its partners or joint venturers, and securities held by a trustee shall be considered to be owned beneficially by each of the beneficiaries, present, future and contingent, of the trust (with certain stated exceptions). This section recognizes the legal principle that such organizations are not separate legal entities. Its intent is to preclude the pyramidng of the number of ultimate sales that could be effected under section 25102(h) by selling, for instance, to partnerships which may have sold interests without qualification under the nonpublic offering exemption of section 25102(f) available for partnership and joint venture interests.

Because of the very wide impact of section 25102(h) there have been numerous requests for interpretive opinions. Most of these have been answered by reference to the express language of the section. This provision was carefully drawn and leaves little room for expansion without amendments to the statute.

One ambiguous reference appears in clause (ii) of subsection (3) which limits the consideration that may be received to “cash or cancellation of indebtedness for money borrowed or both upon the initial organization of the issuer provided all such stock is issued for the same price per share.” The words “initial organization” have been interpreted to mean initial stock issuance and not initial incorporation. This will allow use of the exemption where, for instance, upon incorporation or sometime thereafter two incorporators, A and B, have advanced some part or all of the cash required in the business and commenced operations. Shares can be issued pursuant to the exemption in cancellation of the indebtedness despite the time lag between incorporation and

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(h)(5). The last paragraph of this subsection prohibits the use of section 25102(h) by several corporations to pyramid the ultimate number of issuees and as initially enacted provided that shares issued under the exemption to a corporation which itself had issued stock pursuant to the exemption must be considered to be held “by its shareholders.” As amended the subsection requires that only those to whom shares were issued pursuant to the exemption be counted. Thus if corporation A proposes to issue shares pursuant to the exemption to corporation B which itself had issued shares to five persons pursuant to the exemption but later to ten additional persons pursuant to a qualification, only five are counted in determining the beneficial owners of the shares of A immediately after issuance.

68. Generally, a partnership is not recognized as a separate entity from its members although a separate entity theory has been applied for purposes of various statutes. 3 WITKIN, SUMMARY OF CALIFORNIA LAW 2268 (7th ed. 1960).

69. CAL. CORP. CODE § 25102(h)(3)(ii).

70. MARSH & VOLK at 115.
share issuance (assuming the exemption is otherwise complied with). Under the new law this lag should not be as prevalent since the close-corporation exemption should substantially eliminate delays previously experienced in respect to filing for or obtaining qualification of a securities issuance.

The words "initial organization" have been interpreted, however, to preclude the exemption in the case where cash advances were made by the incorporators, A and B, upon incorporation and sometime thereafter by a third party, C, even though only a few months later. This interpretation is supported by the rationale of the exemption that the consideration paid by each investor must be of the same quality. In the interval before C makes his investment, the business may have deteriorated so that a sale to him at the same price or otherwise on the same terms may be unfair.

Clause (i) of subsection (3)71 in effect allows the use of this exemption where the consideration will consist of the assets of a partnership if all of the proposed issuees have been owners of the partnership during, and the partnership has been operating for, a period of not less than one year immediately preceding the proposed issuance. In addition, the shares must be issued in the same proportion as the ownership of the partnership immediately prior to the issuance. The philosophy of this restriction is that any fraud in the formation of the partnership should have come to light within the year of operation. The requirement that each person receive shares in the same proportion as his ownership in the partnership assets should assure that the investments made by each would be of the same quality. The Commissioner has construed this section to mean that each proposed issuee must have been a partner for the entire year immediately preceding issuance, so that the exemption may not be availed of if a third partner, C, has been admitted to the partnership at any time within the year. Also, the exemption does not apply if shares are proposed to be issued for the assets of two business enterprises. The clause does not preclude the exemption, however, in the case where one partner has withdrawn within the year preceding the issuance.

Marsh and Volk point out in their discussion of this exemption that transfers of stock effected immediately after issuance and issued pursuant to the exemption, whether pursuant to a consent obtained from the Commissioner, or pursuant to one of the exemptions to the requirement of a consent order, should not result in forfeiture of the exemption by

71. CAL. CORP. CODE § 25102(h)(3)(i).
virtue of the “step transaction” doctrine.\textsuperscript{72} The authors note that the words “immediately after” were inserted in the introductory portion of section 25102(h) to make this clear. This brief reference in Marsh and Volk has not been expanded upon or qualified but perhaps should be. As previously noted, this exemption is for a particular transaction and if subsequent transfers of stock, even though occurring shortly after the initial issuance, are in fact separate transactions, there should be no reason for disqualifying the exemption despite the fact that such transfers may increase the number of shareholders to more than five.

Unlike the exemption provided at section 25102(i) for sales to institutional investors, the close-corporation exemption does not require that the initial investors represent that the shares are being purchased for investment and not for resale. In lieu of this requirement the section subjects the shares issued to a restriction on transfer, giving the Commissioner authority to police transfers of shares issued pursuant to the exemption. However, it should be noted that if there will be more than one beneficial owner after issuance, subsection (4) of section 25102(h) prohibits the payment of any promotional consideration. Further, this prohibition is applicable not only against the issuance of stock for promotional consideration but against the payment or incurring of any promotional consideration in cash, stock or otherwise. Therefore, the prohibition cannot be avoided by selling stock to three issuees for cash and thereafter buying a business or assets from one of them at a price in excess of their value which includes payment for promotion.

Section 25151 gives the Commissioner authority to deny a request for consent to transfer securities which are subject to a legend condition imposed by section 25102(h)(1) if he finds that the proposed transfer will not be fair, just or equitable to the proposed transferees. The application form for consent to transfer adopted under section 25151 requires substantially more information or at least more relevant information than was required for such transfers under the prior law.\textsuperscript{73}

For instance, unless the application reflects that the proposed transferee will be either an officer or director or will actively participate at least on a part time basis in the issuer’s business, the form requires additional information as to the relationship of the transferee to the issuer or to its officers or directors as well as information relating to the investment experience of the transferee and the size of this investment in respect to the transferee’s net worth or annual income. Because of the

\textsuperscript{72} Marsh & Volk at 110.

\textsuperscript{73} For a statement of the information required in an application for consent to transfer see Rule 151, Cal. Admin. Code, Title 10.
limitations on the nature of the consideration for which shares may be issued and the authority of the Commissioner to review transfers, use of the close-corporation exemption should not result in significantly less review by the Commissioner than under the prior law.\textsuperscript{74} 

Clause (3) (iv) of section 25102(h),\textsuperscript{75} however, permits the issuance of shares for any legal consideration where there will be only one issuee. The Commissioner has interpreted the words “any legal consideration” in this clause as allowing the issuance of shares for promotional consideration, so that the general prohibition in subsection (4) against promotional consideration does not apply in the case where there is only one issuee. It is possible under this clause for a promoter to set up a corporation, take stock under this exemption for substantial promotional consideration, and thereafter transfer to other purchasers without being subject to Commissioner’s rules both as to amount of promotional shares that may be issued and as to waivers of rules regarding assets and dividends? In this situation the step transaction poses a greater problem. An intentional abuse of the exemption may, of course, result in a finding by either the Commissioner or a court upon suit by shareholders that the exemption was not properly claimed. If, for instance, the promoter files a notice under the exemption in which he represents that there will only be one issuee of the stock but prior to such filing he has agreed to resell shares to others, the notice will be materially defective and the exemption not properly taken. What if at the time of filing the promoter has not actually agreed to sell to others but has formed an intent to resell either to people he has in mind or to the first buyers he can locate? Could a court find that his resales were as an underwriter on behalf of the issuer? The term underwriter is defined in the Federal Securities Act in the board sense to include anyone who buys with a view to distribution.\textsuperscript{76} “Underwriter” is defined in the more restrictive sense under the California law as one who agrees either to purchase securities for distribution or to distribute or manage a distribution of securities on behalf of the issuer.\textsuperscript{77} Although section 25022 does not specifically provide that the agreement need be express, it would probably be tenuous to argue that by purchasing with an intention to resell the promoter has agreed with the issuer to sell. In at least one case under the prior law a California court found by application of the “alter ego” doctrine that resales by promoters of a corporation who, at the ini-

\textsuperscript{74} Under the prior law permits subject to a legend condition were normally issued upon little information where sales were to a very limited number and where there were no promotional considerations.

\textsuperscript{75} CAL. CORP. CODE § 25102(h)(3)(iv).


\textsuperscript{77} CAL. CORP. CODE § 25022.
tiation of such sales, were the owners of substantially all of its shares, were sales on behalf of the issuer. In that case, however, quite clearly the corporation was a mere sham, organized to facilitate theft by the promoters. In other cases under the prior law the alter ego doctrine was referred to by the court to support its finding that resales by a promoter and sole shareholder were on behalf of the issuer or were otherwise issuer transactions.

The facts in each of these cases would have supported a finding under either the prior law or the new law that the sales constituted issuer transactions because the proceeds were paid directly or indirectly to the issuer. Also, in most of these cases the courts were applying section 25152 of the prior law which required a permit for those resales of outstanding shares that were “on behalf of the issuer”; a phrase which offers more latitude in definition than “agreed with.” It cannot be said with certainty, however, that a court, in applying the statute to a situation that has elements of evasion, would not apply a broader definition of “underwriter” than set forth in section 25022 of the new law.

If resales by the promoter and initial issuee are for the direct benefit of the issuer such sales will themselves be subject to qualification as an issuer transaction. Issuer transaction is not defined in the statute; however, “nonissuer transaction” is defined at section 25011 as any transaction not directly or indirectly for the benefit of the issuer. By negative implication, an issuer transaction is directly or indirectly for the benefit of the issuer. Section 25011 also provides that a transaction is indirectly for the benefit of the issuer if any portion of the purchase price of any of the securities involved in the transaction will be received indirectly by the issuer. Thus, if the promoter sells a portion of his outstanding shares and loans any part of the proceeds to the issuer, it is likely that a court would find the sale of the outstanding shares was not an exempt nonissuer transaction but subject to qualification as an issuer transaction.

78. People v. Allen, 47 Cal. App. 2d 735 (1941).
81. See People v. Mason, 184 Cal. App. 2d 317, 372 (1960) holding that the trial court properly refused to give an instruction that there is no illegality in making of a loan by a stockholder to a corporation, even if the funds so loaned are the proceeds of a sale of the personally owned stock of said stockholder.

The Commissioner has relied on an opinion of the Attorney General dated April 5, 1968, to the effect that an issuer transaction is involved where an individual sells personally owned stock and loans the proceeds to the issuer. 51 Op. Cal. Att'y Gen. 40 (1968).
What if the promoter borrows money and issues shares to himself for cash and promotional services and then resells a portion of his shares for cash to repay the loan? This case is not so clear; however, it would seem a court could reach the same conclusion if the transactions were all part of a plan of initial financing. Probably the best assurance against abuse of the exemption is the Commissioner's review of subsequent transfers. The grant of authority in section 25151 appears broad enough to authorize the Commissioner to require a detailed statement of the facts relating to the initial issuance in those cases where shares have been issued to only one issuee and are proposed to be transferred to others immediately after issuance or otherwise. In fact, it is the policy of the State Department of Corporations, in reviewing transfers, to make an initial determination of whether the transfer relates to shares issued pursuant to the exemption and, if so, whether the shares were initially issued to one issuee. In these cases, since there is no way to determine from the face of the exemption notice filed under section 25102(h) whether shares have been issued for promotion, the Commissioner ordinarily will require financial statements and other information to determine how much promotional stock, if any, has been issued. He may then refuse consent to the transfer unless the promoter agrees to subordinate his right to assets and dividends in respect to promotional shares in the manner required by the Commissioner's rules, or unless the promoter demonstrates that the purchaser is sophisticated and knows of the promotional shares outstanding and of their potential dilution of other shares.

**Civil Liability—Rescission and Repurchase Offers**

The new law contains detailed provisions relating to civil liabilities, reflecting another significant change from the prior statute. Sections 25400, 25401 and 25402 prohibit certain conduct, including market manipulation (section 25400), misrepresentation by way of false or misleading statements or omissions (section 25401), and nondisclosure of material information in connection with the purchase or sale of securities by insiders (section 25402). These sections, which are new to California securities law, are modeled after the Federal Securities Act of 1933 and the Securities and Exchange Act of 1934, with certain significant modifications. Liability for violation of these sections is created by sections 25500, 25501 and 25502 providing a specific remedy

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82. These procedures will be complied with unless information in the application for consent to transfer is sufficient to determine that the transaction will be fair.  
83. Draftsmen's Commentary, MARSH & VOLK Appendix A at 650-651.
to the buyer or the seller as the case may be and for a specific measure of damages where damages are available as a remedy. Section 25506 establishes a statute of limitations applicable to violations of sections 25500, 25501 and 25502. Section 25503 provides liability for violations of the qualification provisions of sections 25110, 25120 and 25130. The statute of limitations applicable to violations of the qualification sections is set out in section 25507(a). Other sections relate to indemnification and contribution and the liability of certain principals, control persons, and of employees and brokers or agents who materially aid in acts or transactions constituting a violation of sections 25501 or 25503.

In contrast, the prior law contained essentially one provision relating to civil liabilities, section 26100. It provided that every security "sold or issued" without a permit or in nonconformity with any provision of a permit of the Commissioner is void. That law did not expressly provide either for a right of rescission in the buyer or for damages or a statute of limitations. Section 25518 was added to the statute in 1967, allowing the Commissioner to issue a curative permit to authorize the issuance and sale of any security previously issued or sold without a permit or in nonconformity with a permit previously obtained. Prior to 1967 the statute did not contain an express provision allowing the issuer of a void security to terminate its liability by obtaining a permit or otherwise. Although the securities laws of many states include provisions making sales in violation of the statute void or voidable, the California statute was unique in providing that the security itself was void. California courts, however, interpreted section 26100 to mean that securities sold in violation of the law were voidable at the election of the buyer and not void for all purposes. The courts also worked out details of the buyer's remedy and of the seller's defenses. The latter were essentially limited to the claim that the buyer was in pari delicto.

The counterpart in the new law to old section 26100 is section 25503. This section does not make either a sale made in violation of the law or the securities sold in violation of the law void or voidable but instead gives the buyer the right to bring an action for rescission against any person who violates the qualification provisions of the Act. If the buyer

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84. CAL. STATS. 1949, c. 384, § 1, p. 720.
85. CAL. STATS. 1967, c. 1120, §§ 1.5-4, p. 2781.
86. III Loss, Securities Regulation, 1634 (2d ed. 1961).
88. III Loss, supra note 86, at 1631-1643.
89. The action in rescission allows the successful plaintiff to recover the consideration paid for the security with interest at the legal rate, less income received on the security, upon tender of the security.
no longer owns the security he is entitled to damages. Section 25507(a) provides that the statute of limitations applicable to liability under section 25503 is two years from the violation or one year after discovery of the violation by plaintiff, whichever occurs first.

However, subsection (b) of section 25507 provides the seller with a procedure for terminating his liability in a much shorter period. Under this subsection, the seller may make an offer to repurchase the security for cash; or to pay damages in an amount recoverable by the buyer under section 25503; or to rescind the transaction by putting the parties back in the same position as before the transaction. If, before suit is commenced, the buyer has received an offer pursuant to this subsection, he is barred from commencing an action for rescission or damages under section 25503 unless he accepts the offer within the period specified by the seller (which may not be less than 30 days). However, the repurchase offer, which is required to be in writing, must be approved as to form by the Commissioner; it must state the manner in which liability under section 25503 may have arisen; it must set forth the provisions of subdivision (b), and must contain such other information as the Commissioner may require by rule or order. This subdivision of section 25507, as well as the statute of limitations in subdivision (a), was modeled after section 410(e) of the draft Uniform Securities Act which has been adopted by a number of other states.90 As it appears in the California statute, however, the section reflects modifications of the Uniform Act, the most significant being the requirement that the repurchase offer under section 25507(b) be approved as to form by the Commissioner and contain such other information as the Commissioner may, by rule or order, require.91

There are, as yet, no California appellate cases interpreting either section 25503 or 25507. Some of the questions raised by these sections will not be clarified until litigated. Nevertheless, a number of conclusions can be drawn from the overall purpose and intent of the civil liability sections of the statute. It seems quite clear that a seller cannot assert the buyer's failure to accept a repurchase offer not made in compliance with section 25507(b) as a bar to an action by the buyer.92 Also, even if the buyer has, by agreement, purportedly waived a right of rescission, or specifically rejected the seller's repurchase offer made without reference to or compliance with section 25507(b), the seller cannot assert the

90. Draftsmen's Commentary, MARSH & VOLK, Appendix A at 654-657.
91. Id. at 657.
statute as a bar to a later action by the buyer, but must plead the waiver and rely on principles of contract or estoppel to bar the buyer's suit.

Is a repurchase offer under section 25507(b) the only method of terminating the seller's liability prior to the expiration of the two-year statute of limitations? Subsection (b) is intended as a special remedy to the seller who, without some way of "curing" a sale in violation of the statute, is subject to the uncertainty of contingent liabilities until the two-year limitations period has expired. If the seller does not seek the benefit of the subsection—forcing the buyer either to affirm the sale or accept rescission within the 30-day period—arguably he can still solicit a binding affirmance by the buyer without complying with section 25507(b). The law is not clear, however, as to the effect of a purported waiver by the buyer of the statutory right of rescission under either state or federal securities law. There are many cases dealing with laches and estoppel but few dealing directly with the question whether an agreement between the seller and purchasers where the purchaser waives his right of rescission will preclude a later suit by the purchaser.\footnote{93} Generally courts have been reluctant to apply the doctrine of estoppel to bar recovery by the buyer. This has been especially true in California where, under the prior law, a security sold in violation of the statute was void.\footnote{94} Some opinions, however, have suggested in the appropriate case the buyer's suit may be barred by the defense of waiver.\footnote{95}

There are some obstacles which would make rescission offers effected outside of section 25507(b) unreliable as a defense. In denying the seller's defense that the buyer is estopped, courts have frequently referred to the strong public policy of securities regulation which favors protecting the buyer.\footnote{96} Professor Louis Loss suggests that anti-waiver provisions, such as Section 14 of the Securities Act of 1933, should aid a buyer asserting a violation as against any arguments directed by his adversary to ratification or estoppel as well as waiver.\footnote{97} The Corporate Securities Law of 1968 includes an anti-waiver provision in substantially the same language as that in the federal statute.\footnote{98} Cases that have

\footnote{93. See III Loss, supra note 86, at 1677, and Dahlquist, supra note 87, at 700, citing cases (mostly under the prior California law) dealing with ratification, estoppel and laches.}

\footnote{94. See III Loss, supra note 86, at 1677-1680. See also N. C. Roberts Co. v. Topaz Transformer Products, Inc., 239 Cal. App. 2d 801 (1966), and cases cited therein.}

\footnote{95. See Royal Air Properties v. Smith, 333 F.2d 568 (1964). See also Note, Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10b-5: Deterrence and Equity in Balance, 73 YALE L.J. 1477 (1964), for a discussion of estoppel and waiver under federal and state securities laws and for a list of cases relating to estoppel and waiver.}

\footnote{96. See, e.g., Randall v. California Land Buyers Syndicate, 217 Cal. 594 (1933).}

\footnote{97. III Loss, supra note 79, at 1815.}

\footnote{98. CAL. CORP. CODE § 25701.}
arisen under the 1933 Act interpreting Section 14 suggest that although the section prohibits the solicitation of a waiver at the time of sale, it would not preclude waivers after the right has arisen.\textsuperscript{90} There is dictum in one case applying the Securities and Exchange Act of 1934 to the effect that a knowledgeable waiver by the buyer executed after the liability has arisen may be binding.\textsuperscript{100}

The courts may find less trouble with a bona fide settlement between a seller and a buyer who has filed a lawsuit and is represented by counsel, but a rescission offer initiated by the seller and made to ordinary investors who may not be represented by counsel presents a more difficult question. Section 25507(b) requires that a repurchase offer under that section state the respect in which liability under the section may have arisen and it would seem that courts would demand that rescission offers made outside of the section, if they are to be binding, clearly apprise the buyer of the nature of the liability and of his remedy.\textsuperscript{101} The courts may go further and require disclosure of material information about the security and the condition of the issuer which may be necessary if the buyer is to understand the value of the right he is waiving. In effect this is the standard set by section 25507(b), as discussed later herein, which authorizes the Commissioner to require disclosure of these facts.

Would the affirmance of a sale of securities be binding on the buyer if the seller failed to disclose in his rescission offer material information which substantially affected the value of the security? In the first place, the buyer’s rejection of a repurchase offer made pursuant to section 25507(b) does not operate to cut off his right to sue under either section 25501 or 25502 for damages for misrepresentations in respect to the initial sale. Likewise, an affirmance of the sale made outside of section 25507(b) should not have that effect unless it clearly purports to deal with and settle the buyer’s claim with respect to those violations.

A separate question is presented, however, as to whether active misrepresentation or nondisclosure of material facts concerning the condition of the issuer or other facts affecting the value of the security at the time the rescission offer is made could later be set up the buyer to support a rescission of the agreement validating the sale. A repurchase offer made pursuant to section 25507(b) would not appear to involve the sale of a security subject either to qualification or to section 25501

\textsuperscript{90} Wilko v. Swan, 346 U.S. 427 (1953).
\textsuperscript{100} Royal Air Properties, Inc. v. Smith, 333 F.2d 568 (1964).
\textsuperscript{101} In Royal Air Properties v. Smith the court said, “Since waiver is a voluntary act, there must be knowledge of the right in question before the act of relinquishment can occur.” 333 F.2d at 571. The court did not say how much information the buyer should have.
which creates liability for misrepresentations in the sale or purchase of securities. It would appear, therefore, that an agreement entered into outside the provisions of section 25507(b), which is no more than a waiver by the buyer of his right to the remedy of rescission and restitution, would not constitute the sale of a security. Consequently, section 25501 would not apply. The facts in a particular case, however, may warrant the conclusion that a new security has been sold. If the agreement, for example, alters any of the terms, including the price, of the security initially sold, it may result either in the exchange of an entirely new security for the outstanding security, or in an investment contract. In any event, under common law principles, the seller's misrepresentation of material facts upon which the buyer relied should be grounds for rescission and it is likely that a court would apply securities law standards in determining materiality.\footnote{102. See The Relation Between Common Law Deceit and SEC Fraud Concepts, III Loss, supra note 79, at 1430-1445, c. 9B.}

In addition to providing the seller with a statutory bar to a suit by the buyer, repurchase offers pursuant to section 25507(b) provide the seller the advantage of a review by the Commissioner and disclosure of facts which the unsophisticated seller may not have considered important.

The issuer does not have the alternative remedy under the new law of obtaining either a formal or informal curative permit. Under the prior law, sections 25518 through 25521,\footnote{103. Cal. Stats. 1967, c. 1120, §§ 1.5-4, p. 2781.} the Commissioner was authorized to issue a curative permit, and directed the courts to stay any pending civil proceeding relating to issues based on violation of the law if the court found that there was a prima facie basis for an ultimate finding by the Commissioner that issuance of the permit would be fair, just and equitable. These sections dealing with curative permits have been carried over into the new law but are expressly limited to transactions occurring prior to the effective date of the new law. In addition, issuers who wish to obtain the benefits of the alternative remedies must do so prior to January 2, 1972, for the remedy will expire on that date as to transactions occurring prior to January 2, 1969.\footnote{104. Cal. Corp. Code §§ 25800-25804.} Under the prior law, both before and after the curative permit sections were added in 1967, it was the practice of the Commissioner to issue "informal curative" permits where a sale had occurred prior to obtaining a permit. In these cases the applicant was required, either prior to issuance of the permit or prior to the issuance of securities pursuant to the permit, to make a rescission offer to the purchaser explaining the nature of the violation and his right to restitution and to submit evidence to the Com-
missioner of the buyer's waiver of his right of restitution. Most fre-
quently this procedure was used to cure mere technical violations where,
although a sale had occurred as defined in the statute, consideration 

had not passed.

The Commissioner has interpreted the new law to preclude the is-
suance of a permit where a sale has occurred and where all or some 
part of the consideration has been paid prior to qualification. The 
principal argument supporting this conclusion is that section 25507(b) 
provides a specific and adequate remedy to the seller. Also the new law 
does not render void the security which is sold or issued without quali-

fication and there is no necessity of qualifying the securities as a pre-
requisite to rendering an opinion that they are validly issued. As a 
corollary, since the statute prohibits offer and sale and not "issue", it is 
clear that after a sale in violation of the statute has occurred, the issuer 
can complete the transaction by issuing securities without further viola-
tion. This result produces an interesting paradox in that the issuer, who 
by oversight has violated the law but who wishes to show compliance 
by applying for a permit, is unable to do so unless the consideration 
received from the buyer is returned and a complete rescission effected. 
The issuer may then initiate the transaction once again. It may be diffi-
cult, of course, to undo the entire transaction, especially if there are a 
number of buyers or if the proceeds have been applied in the business.

There are several areas where the inadvertent sale may occur and 
which warrant special consideration by counsel. For instance, where 
notes are issued to a closed group with an express understanding that 
the notes are to be exchangeable for stock, a sale would occur whether 
or not such agreement is in writing.105 Even though the notes are is-
sued to only a few people under circumstances which would otherwise 
meet the definition of a nonpublic sale under Rule 102.2, the sale will 
not be exempt for the nonpublic offering exemption does not apply to 
convertible notes.106

Options present another problem. Under the prior law the issuance 
of an option involved an offer of the underlying security but not a sale. 
There was considered to be no sale of either the underlying security or 
of a security embodied in the option contract itself.107 Section 25019 
of the new law defines security to include an option.108 Also under 
section 25017 the sale of the underlying security occurs at the time of 

106. See CAL. ADMIN. CODE, Title 10, § 260.102.3.
107. CAL. CORP. CODE, former § 25009(c).
108. The section refers to a "warrant or right to subscribe to or purchase (a 
security)."
sale of the option; the issuance of the underlying security upon exercise of the option is excluded from the definition of sale. Thus the issuance of an option for value, or the payment of consideration in respect to an agreement to issue an option involves the sale of a security which must be qualified.

Options may be created in employment agreements without due regard to the Corporate Securities Law. Whether an option has in fact been granted or issued and whether consideration has been given for the grant of an option is a question of fact to be determined in each case. Arguably, however, value is given when options are granted by the terms of an employment agreement by which an employee is induced to leave existing employment and commence employment with the issuer. The case is even stronger where the employment agreement includes an agreement whereby the employee becomes entitled to shares after a period of employment without the payment of additional consideration. If a sale of options occurs prior to qualification a very troublesome question may be presented concerning what the seller must offer to return in connection with a repurchase offer under section 25507(b).

Civil liability does not arise under section 25503 if the sale of the security is qualified prior to the payment or receipt of any part of the consideration for the security sold. This is true even though an offer to sell or a contract of sale may have been made or entered into without qualification. Options issued without the payment of consideration arguably are only offers, so that qualification would be possible if made before any consideration is paid.

Section 25102(a) provides that the execution of a subscription agreement will be exempt from qualification if certain conditions are met. To be exempt the agreement must not be offered to the public; it must be conditioned upon qualification in the express language required by section 251102(a); and no consideration must be received in respect to the agreement. A subscription agreement which is not expressly conditioned upon qualification would constitute a sale, being both an agreement of the seller to sell and an agreement of the buyer to purchase a security. However, the security subscribed for could be qualified as long as the consideration has not been paid. In either of these cases, however, it appears that as a condition to obtaining qualification the seller should be required to advise the buyer that the contract is not enforceable should the buyer elect not to complete the purchase.

As indicated above, subsection (b) of section 25507 requires that the repurchase offer be approved as to form by the Commissioner and

contain such other information as the Commissioner may require by rule or order. Pursuant to this subsection the Commissioner has promulgated Rule 507 which requires that the repurchase offer include a statement to the effect that the Commissioner has approved the offer in accordance with section 25507(b) only as to its form; that the approval does not imply a finding by the Commissioner that any statements made in the offer or in any accompanying documents are true or complete; and that the approval does not imply a finding by the Commissioner that the amount offered by the seller is equal to the amount recoverable by the buyer of the security in accordance with section 25503. The rule also requires the usual caveat that the Commissioner does not endorse the offer and makes no recommendation as to its acceptance or rejection.

In addition, the Commissioner has required, and probably should require in each case, that a repurchase offer include at least the following information: (1) the names and addresses of all persons to whom the offer is to be made; (2) the specific amount of cash stated as a monetary sum to be offered to each person; (3) the time within which the payment will be made if the offer is accepted; (4) sufficient information to clearly identify the securities transaction to which the offering relates including the name of the issuer, a specific description of the security, and the date and nature of consideration received; (5) a statement clearly indicating that the buyer's right of action, if any, under sections 25500, 25501 and 25502 is not necessarily foreclosed by a failure to accept the offer; and (6) where it appears that the offeror does not have sufficient funds to fund the offers proposed to be made, a disclosure that others may be liable under the provisions of section 25504. The Commissioner has taken the position that the offer cannot be approved as to form if it is subject to any conditions not specifically authorized by section 25507(b).

The language of subsection (b) appears sufficiently broad to authorize the Commissioner, in a particular case, to require, in addition to those items above, the submission of detailed information as to the nature of the business and financial condition of the issuer; information as to the particular terms of the offering of securities which were not qualified; and full disclosure by the offeror to the buyer of all material facts as to the business and financial condition of the issuer, including substantially the same kind of information as would have been required had the sale been qualified. Moreover, the present financial condition of the issuer as well as any material facts that may affect the present value of the security may be required to be disclosed to the buyer. Al-
though the Commissioner does not have authority to reject repurchase offers made under section 25507(b) on the basis that the initial sale or an affirmance of the contract would not be fair, just and equitable, the "fair, just and equitable" standard, in effect, must be applied to determine the nature of the disclosure that must be made to the buyer.

The information developed from this disclosure will enable the Commissioner to determine whether criminal action may be warranted in respect to either a willful violation of the qualification sections or in respect to misrepresentations which may have been made at the time of the initial sale in violation of section 25401 or 25402. Disclosure to the buyer will provide him with information from which he can determine whether to accept the repurchase offer or to reject it and retain the investment. Even if the buyer rejects the repurchase offer, his right to sue for damages under section 25501 or 25502 is not foreclosed and the disclosure made in respect to a repurchase offer may reveal to the buyer misrepresentations made in connection with the initial purchase that were in violation of these sections.

Conclusion

The Corporate Securities Law of 1968 is a carefully drafted statute which effects a complete overhaul of the prior law. The new statute is more explicit in many areas and eliminates many questions that had developed over the years under the prior law. Counsel dealing with the new securities law will, however, discover the need for a broader understanding of the law as a whole since it is much more comprehensive and effects changes in almost every area covered by the prior statute, a few of which have been considered here. The Department of Corporations encourages informal discussions between counsel and staff members of the department concerning the application of the statute. Where a question cannot be resolved by reference to the express language of the statute or through informal discussions with staff members, counsel may request an interpretive opinion as to the prospective applicability of the new law to a particular transaction.