McGeorge Law Review

Volume 21 | Issue 2 Article 3

1-1-1990

Issuer Recovery of Insider Trading Profits under Section 25502.5 of the California Corporation Code

Don Berger
University of the Pacific; McGeorge School of Law

Articles

Issuer Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporation Code

Don Berger*

Insider trading—the use of confidential information not available to the trading public to purchase or sell securities—is prohibited under federal law by section 10(b) of the 1934 Securities Exchange Act[1] and Rule 10b-5[2] adopted by the Securities Exchange Commission

---

* Professor of Law, McGeorge School of Law, University of the Pacific; J.D., University of California, Hastings College of Law, 1964; LL.M., University of Illinois, 1965.

1. 15 U.S.C. 78j(b) (1934): "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

> (a) . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. 17 C.F.R. § 240.10b-5 (1988): "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

pursuant to that statutory provision.[3] Such conduct is also prohibited under provisions of the California Corporate Securities Law of 1968.[4]

The traditional theoretical justification for prohibiting insider trading is based on the notion that allowing persons who have access to non-public information to use it for securities trading will discourage individual investors without access to such information from trading in the securities markets. Thus, even though persistent arguments have been made by some economists that insider trading is good for the trading markets as a whole and should be permitted,[5] the overwhelming reaction in fact has consistently been to regard it as "unfair" because it destroys the "level playing field" among participants in the trading markets.[6]

In recent years, however, the public objections to insider trading have assumed larger dimensions. While at one time governmental prosecution of small-time insider trading might have been regarded by the general public as overzealous,[7] the discovery of persistent,

---

3. The development and scope of the federal insider trading laws is detailed in D.C. LANGEVOORT, INSIDER TRADING REGULATION (1989).

4. 1968 Cal. Stat., ch. 88, sec. 2 at 279 (enacting CAL. CORP. CODE § 25402).

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

Id.

1968 Cal. Stat., ch. 88, sec. 2 at 280 (enacting Cal. Corp. Code § 25502).

> Any person who violates Section 25402 shall be liable to the person who purchases a security from him or sells a security to him, for damages equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information, plus interest at the legal rate, unless the defendant proves that the plaintiff knew the information or that the plaintiff would have purchased or sold at the same price even if the information had been revealed to him.

Id. See generally Review of Selected California Legislation, 20 PAC. L.J. 423, 465-66 (1988).

5. *See, e.g.*, H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). *See also* Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980); Wu, *An Economist Looks at Section 16(b) of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968).

6. S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 875 (2d Cir. 1968) ("the rule [against insider trading] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information").

7. In Chiarella v. United States, 445 U.S. 222 (1980), the weight of the federal government

systematic insider trading activities yielding millions of dollars in profit to well-known securities professionals such as Ivan Boesky and Dennis Levine has changed the underlying objection to insider trading to one of basic morality and cultural values. Comments such as Ivan Boesky's "Greed is all right . . . greed is healthy"[8] might have been inspirational to his audience of business school students; the reaction of both the investing public without access to Mr. Boesky's sources of inside information and the non-investing general public was one of moral indignation. As described by one leading writer, "Congress has begun to see the problem in more fundamental cultural terms as a manifestation of undue greed among the already well-to-do, worthy of legislative intervention if for no other reason than to send a message of censure on behalf of the American people."[9]

At the federal level, the first major legislative response to these revelations of widespread and large scale insider trading activities was the enactment of the 1984 Insider Trading Sanctions Act.[10] The major new provision of this statute empowered the Securities Exchange Commission (SEC or Commission hereafter) to seek the judicial imposition of civil fines of up to three times the amount of the illegally obtained profits from insider trading.[11] Compared to the previous maximum monetary liability in SEC civil enforcement actions—judicially ordered disgorgement of profits only[12]—the additional imposition of civil fines was thought to create a meaningful deterrent to potential violators.

The subsequent unravelling of the Dennis Levine—Ivan Boesky scandal, and the discovery of post-1984 insider trading activities by securities industry professionals caused a second Congressional enactment—the 1988 Insider Trading and Securities Fraud Enforcement Act.[13] This statute, too, expressed Congress' reaction to the new and

---

was exerted in the form of an ultimately unsuccessful criminal prosecution against an employee of a printing company who had made trading profits of $30,000 over a period of fourteen months.

8. Speech to business school students, 1985, quoted in 134 Cong. Rec. H7469 (daily ed. Sept. 13, 1988).

9. D. Langevoort, *supra* note 3, at 1.

10. Pub. Law 98-376, 98 Stat. 1264 (1984) (enacting 15 U.S.C. § 78a, c, o, t, u, ff).

11. 15 U.S.C. § 78u-1 (1988).

12. D. Langevoort, *supra* note 3, at 227 ("[t]he courts have recognized this form of ancillary equitable relief, as an appropriate incident to the Commission's enforcement powers—even though the statute itself does not affirmatively grant . . . such authority"). *See also* Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 Duke L.J. 641.

13. Pub. Law 100-704, 102 Stat. 4677 (1988) (enacting 15 U.S.C. § 78a, b, c, k, o, t, u, kk). *See* Lavoie, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 22 Rev. Sec. & Commodities Reg. 1 (1989).

widespread public indignation based on notions of morality and fairness. As stated by Representative John Dingell (D-Mich.):

> Underlying the explosion of [insider trading] is a certain economic and social Darwinism which holds that the strong were meant to prevail over the weak, and the strong have no accountability. They are free to do what they want and their success proves the rightness of their course of conduct . . . Well, this bill will, in a limited way, control and restrain greed.[14]

The previous references to the new public reaction against insider trading and to the new federal statutes were made for the limited purpose of painting a backdrop. The substantive focus of this article is not to deal with the federal law of insider trading but with a newly enacted and so far unique piece of state legislation—the addition of section 25502.5 to the California Corporations Code through the enactment of S.B. 2578 in 1988.[15]

This article posits that the California Legislature enacted section 25502.5 too hastily in a milieu of "me too-ism." Further, this article expresses the author's belief that section 25502.5 represents an emotional legislative response to insider trading that will likely generate litigation that could and should have been avoided through better drafting.[16]

Substantiation for these conclusions will be provided by a substantive comparison of section 25502.5 to section 16(b) of the 1934 Securities Exchange Act,[17] the presumed model for the new California provision. Judicial application and interpretation of section 16(b) will

14. 134 Cong. Rec. H7469 (daily ed. Sept. 13, 1988).

15. 1988 Cal. Legis. Serv. ch. 1339, sec. 4 at 4999 (West) (enacting CAL. CORP. CODE § 25502.5). S.B. 2578, enacted as Chapter 1339 in 1988, made other changes in the California Corporate Securities Law of 1968. It added section 25213.3 to the California Corporation Code which requires the Commissioner of Corporations to suspend or bar an employee or officer of a broker-dealer if that person has been convicted of violating the anti-fraud provisions of the Corporate Securities Law. *Id.* sec. 1, at 4998 (enacting CAL. CORP. CODE § 25213.3). Additional provisions of S.B. 2578 amended sections 25540 and 25541 to increase the criminal penalties for violations to $250,000 and prison terms from one year in a county jail to two, three or five years in a state prison. *Id.* sec. 5, at 4999 (amending CAL. CORP. CODE § 25540); *id.* sec. 6, at 4999 (amending § 25541). A bill substantially identical to Chapter 1339 was introduced in 1987, but was vetoed by Governor Deukmejian because of concerns that the bill had overbroad applications. Deukmejian, Governor's Veto Message to the Senate on SB 1666; SENATE J., 4117, Oct. 1, 1987 (1987 Reg. Sess.). *See Review of Selected California Legislation*, 20 PAC. L.J. 423, 466 n.6 (1988).

16. Lest these critical remarks be misunderstood, the author of this article firmly believes that insider trading should be prohibited and violators subjected to appropriate civil and criminal liability.

17. 15 U.S.C. § 78p(b).

be relied on to point out the potential problems in the application of section 25502.5 to private litigation.

I. SECTION 25502.5: THE BASICS

Newly enacted Section 25502.5 of the California Corporations Code provides that any person who violates section 25402 by trading on the basis of non-public information can be held liable *to the issuer* whose securities were traded.[18] Encompassed by the term "any person," as a result of the cross-reference to section 25402, are officers, directors and controlling persons of an issuer as well as "any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public."[19] The monetary liability imposed by section 25502.5 can be for up to three times the amount of the illegally obtained profit.[20] An action to recover such liability can be instituted by the issuer or a shareholder of the issuer.[21] A person found liable must also pay the reasonable costs and attorney's fee of the successful plaintiff.[22]

A defendant's liability must, however, be reduced by the amount such defendant has paid in an action brought by the SEC involving the same trading activities.[23] If such an SEC action is still pending without final resolution, the California court must delay the rendition of a California judgment until the federal action is concluded.[24] The remedy provided by section 25502.5 does not apply to issuers having assets of less than $1 million and a class of equity securities held of record by 500 or more persons.[25]

II. SECTION 16(B) UNDERPINNINGS

The only statutory equivalent to section 25502.5 can be found in section 16(b) of the 1934 Securities Exchange Act[26]—the so-called

18. CAL. CORP. CODE § 25502.5(a) (West Supp. 1989).
19. CAL. CORP. CODE § 25402 (West 1977).
20. CAL. CORP. CODE § 25502.5(a) (West Supp. 1989).
21. *Id.*
22. *Id.*
23. *Id.* § 25502.5(b).
24. *Id.*
25. *Id.* § 25502.5(d).
26. 15 U.S.C. § 78p(b) (1964). Under federal law, the monetary liability for insider trading

"short swing profit" provision. It is therefore logical to compare these two provisions. Section 16(b) has been the subject of extensive litigation in the federal courts. Presumably, therefore, its historical application and interpretation by the federal courts can be utilized to analyze the meaning and potential impact of section 25502.5 of the California Corporation Code.

Except for new section 25502.5 of the California Corporations Code, no other state presently has a statutory provision making a person using inside information liable to the issuer of that security.

A brief mention of insider trading liability to the issuer of the traded security under *non-statutory* state law is in order, however. Up to the present time, the imposition of such liability has been approved in only three states.[27] Such non-statutory liability under state law has been rejected by two courts.[28] The controversial aspect of such liability is that normally the issuer in whose favor the monetary recovery for insider trading is sought has sustained no monetary damages from the insider's use of confidential information for trading purposes.[29] The enactment in California of section 25502.5 thus seems to be an important legislative decision that the absence of monetary injury to the issuer of the traded security is less important than the deterrent of insider trading by superimposing issuer-directed profit disgorgement to the already existing liability towards the person whose securities the insider purchased or towards the person to whom the insider sold.

Section 16(b) of the 1934 Securities Exchange Act imposes liability on officers, directors and beneficial owners[30] to the issuer of the securities that were traded.[31] Designed for the purpose of "preventing the unfair use of information" obtained by such statutory insiders, the statute provides for the disgorgement of profits obtained by them

in civil cases normally consists of a disgorgement to the government of the illegally obtained profits and possibly the payment of a civil fine. 15 U.S.C. § 78u-1 (1988). However, in a private suit, the inside trader must disgorge illegally obtained profits to any "contemporaneous trader". 15 U.S.C. § 78t-1 (1988).

27. *In re* ORFA Securities Litigation, 654 F. Supp. 1449 (D.C. N.J. 1987); Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

28. Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (applying Indiana law); Schein v. Chasen, 313 So. 2d 739 (Fla. 1975).

29. Wimberly, *Corporate Recovery of Insider Trading Profits at Common Law*, 8 CORP. L. REV. 197 (1985).

30. A "beneficial owner" is any person who owns more than ten percent of a class of equity securities registered pursuant to section 12 of the 1934 Securities Exchange Act. 15 U.S.C. § 78p(a).

31. 15 U.S.C. § 78p(b).

from any purchase and sale, or sale and purchase, occurring within less than six months.[32]

Despite their basic underlying similarity, section 25502.5 and section 16(b) differ in one important respect. Section 16(b) liability is not dependent upon the defendant's actual knowledge and use of "inside" information.[33] A statutory insider is liable under section 16(b) if any two transactions yielding a profit occurred within the specified time period. In other words, liability is the result of the mere *status* as a statutory insider of the trading person. Section 25502.5, on the other hand, requires that the defendant must have also violated section 25402 of the California Corporations Code.[34] Thus, the California statute clearly requires the *use* of inside information by the defendant; mere *status* as a "statutory insider" is not sufficient.

On the other hand, section 25502.5 is broader than section 16(b). The federal provision requires a pairing of two transactions occurring within less than six months.[35] The California provision, on the other hand, permits the imposition of profit liability for any one transaction if inside information was in fact used.[36]

Beyond this clear difference between the two statutes, varying degrees of doubt and uncertainty about the intent and meaning of section 25502.5 arise. These will be examined below by attempting to glean the meaning of the California provision in light of the history of section 16(b), its federal philosophical parent.

III. THE ROLE OF THE PLAINTIFF

The language of section 25502.5 indicates obliquely, rather than expressly, that the issuer of the traded security or a person suing in

---

32. *Id.*

33. 3B H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 10.01(6) (1989).

> Although the liability under Section 16(b) is designed to limit the opportunity for insiders to trade to their advantage on the basis of inside information, it is not necessary for plaintiff to establish that in fact insiders traded on the basis of such information. The section's operation is prophylactic; it is designed to preclude transactions with a potential for abuse irrespective of actual abuse.

Id. An exception to this strict liability doctrine is the so-called "unorthodox transaction" concept applied by the Supreme Court in Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973). *See* Note, *Exceptions to Liability Under Section 16(b): A Systematic Approach*, 87 YALE L.J. 1430 (1978).

34. *See supra* note 4.

35. 15 U.S.C. § 78p(b).

36. CAL. CORP. CODE § 25502.5(a).

the right of the issuer is an appropriate plaintiff because subsection (a) makes the defendant liable for the reasonable costs and attorney's fees of these two types of plaintiffs.[37]

A. The Demand Requirement

Unfortunately, the statutory language does not answer several crucial issues pertaining to the role of the plaintiff in section 25502.5 litigation if that plaintiff is someone other than the issuer. Referred to in subsection (c) as a "shareholder" and in subsection (a) as a "person who institutes an action under this section in the right of the issuer," such a plaintiff presumably is pursuing what would normally be regarded as a derivative suit, since the language of the statute clearly makes the violator "liable to the issuer of the security purchased or sold."[38]

Derivative suits, under section 800 of the California Corporations Code, are subject to several prerequisites. The plaintiff must make a pre-litigation demand on the board of directors, to rectify the wrong done to the corporation, unless such demand is excused as futile.[39] Furthermore, a derivative plaintiff must be a so-called "contemporaneous owner," i.e., must have been a shareholder of the corporation at the time the alleged wrong to the corporation occurred. This requirement discourages plaintiffs from purchasing shares simply for the sake of instituting litigation.[40] A derivative plaintiff can also be required, upon motion by the corporation or the defendant, to post a bond in an amount not to exceed $50,000 as security for the potential litigation expenses of the corporation and the defendant.[41]

Whether these requirements applicable to the normal derivative suit are applicable in section 25502.5 litigation brought by a person in the right of the issuer is at least debatable. The pre-litigation demand principle is not spelled out in the statute; subsection (c) only refers to the *possibility* of a shareholder's allegation to the board that a violation has occurred, and then only in the context of

---

37. *Id.* ("Any person . . . who violates Section 25402 . . . shall be liable to the issuer of the security *or to a person who institutes an action under this section in the right of the issuer* of the security for reasonable costs and attorney's fees.") (emphasis added).
38. *Id.*
39. *Id.* § 800(b)(2) (West Supp. 1989).
40. *Id.* § 800(b)(1).
41. *Id.* § 800(c), (d).

imposing upon the board a duty of a good faith reaction.[42] There is no cross-reference in section 25502.5 to section 800.

The absence of an express reference to the demand requirement may be regarded as simply an implied declaration of legislative intent to subject this kind of litigation to the requirements of a "normal" derivative under section 800. On the other hand, section 16(b), the federal sibling of section 25502.5, expressly requires that the shareholder make a pre-litigation demand on the board of directors;[43] such a shareholder can only sue derivatively if the board fails to take action under section 16(b) within sixty days after the shareholder's demand or if the board improperly refuses to act. It must be emphasized that the federal demand requirement is express in section 16(b) even though Rule 23.1 of the Federal Rules of Civil Procedure—the provision setting forth the general requirements for *all* derivative suits in the federal courts—already contains a pre-litigation demand requirement.[44]

Thus, a dilemma results under section 25502.5—is there a demand requirement because such a suit is a "normal" derivative suit? Or is such a demand permitted but not required because, unlike section 16(b), no specific requirement is expressed, thus creating a difference between these two philosophically related provisions?

B. Contemporaneous Ownership: Required or Not?

The "contemporaneous ownership" principle is also not expressly referred to in section 25502.5. Arguably, the absence of such a requirement simply demonstrates a legislative intent to regard section 25502.5 suits as "normal" derivative suits and thus subject to the contemporaneous ownership requirement of section 800. However, section 25502.5's relationship to section 16(b) is once again grounds for a contrary argument. The federal courts have consistently held that although section 16(b) suits brought by a shareholder are derivative in nature for some purposes, a shareholder plaintiff need *not* have been a "contemporaneous owner."[45]

---

42. *Id.* § 800(c).

43. 15 U.S.C. § 78p(b) ("Suit to recover such profit may be instituted at law or in equity . . . by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days *after request* . . .") (emphasis added).

44. FED. R. CIV. P. 23.1.

45. Blau v. Oppenheim, 250 F. Supp. 881 (S.D.N.Y. 1966). 3B H. BLOOMENTHAL, *supra*

Apart from the express language in section 16(b) permitting "any" security owner to sue, dispensing with the "contemporaneous ownership" requirement can also be justified on policy grounds. Section 16(b) can only be enforced by private litigation; the Securities Exchange Commission has no authority to initiate 16(b) actions.[46] In order to obtain maximum enforcement, section 16(b) is normally interpreted liberally in favor of plaintiffs.

It is debatable whether the same rationale should apply to private actions under section 25502.5. The California provision is triggered when insiders in fact have used inside information, whereas 16(b) liability is imposed even if no inside information has been used.[47] The losing defendant in a section 25502.5 action has violated section 25402 and therefore can be prosecuted criminally.[48] There is thus not the same need as in section 16(b) actions to make life easy for the plaintiff by eliminating the contemporaneous ownership requirement as a matter of policy.

The statute's lack of clarity with regard to both the demand and the contemporaneous ownership requirements is unfortunate. Since arguments for both the existence and the non-existence for these requirements can be made, as pointed out above, only litigation or legislative amending action will provide an ultimate answer.

IV. Defendant's Dilemma: Potential Double Liability

Section 25502.5 imposes upon a violator of section 25402

> damages in an amount up to three times the difference between the price at which the security was purchased or sold and the market value which the security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information . . .[49]

For example, assume Smith, a vice-president of Acme, Inc., knowing confidential information about Acme, purchases 1,000 Acme shares

---

note 31, at § 10.02 ("Although Rule 23.1 of the Federal Rules of Civil Procedure requires generally that plaintiffs in a derivative action have been shareholders at the time of the wrong complained of this provision is not applicable to a 16(b) action in view of the fact that 16(b) expressly provides that *any* security holder may initiate the action.").

46. 3B H. Bloomenthal, *supra* note 33, at § 10.02.
47. *See supra* note 36, and accompanying text.
48. Cal. Corp. Code § 25540 (West Supp. 1989).
49. *Id.* § 25502.5(a).

for $20 per share based on that information. Upon release of that information to the public, the market price of Acme shares rises to $40 per share. Smith sells her 1,000 shares, making a $20,000 profit. Section 25502.5 would subject Smith to a maximum liability of $60,000 to Acme, Inc., assuming that the trading price of Acme shares would have risen to $40 had the confidential information been made public prior to Smith's purchase.

Such liability, however, must be reduced "by any amount paid by the defendant in a proceeding brought by the Securities and Exchange Commission with respect to the same transaction or transactions under the federal Insider Trading Sanctions Act . . . or any other act . . ."[50] Thus, if the SEC had brought a civil action against Smith as a result of which she had made a disgorgement of her profits, and perhaps paid an additional civil fine, her liability to Acme, Inc. under section 25502.5 would be reduced or completely eliminated correspondingly. Section 25502.5(b) thus clearly evinces an intent to protect the defendant against double liability, at least to a limited extent.

However, the concern with potential multiple liability underlying the reduction of liability under section 25502.5(b) leaves open the possibility of multiple liability in related situations. Only amounts paid by the defendant "in a proceeding brought by the Securities Exchange Commission" can be used as an off-set to section 25502.5 liability.[51] Thus, since the SEC cannot bring section 16(b) actions,[52] amounts paid by the defendant to the issuer of the traded security under section 16(b) presumably cannot be used to reduce 25502.5 liability. Nor can amounts paid by the defendant to a private plaintiff under section 20A of the Securities Exchange Act be so used.[53] Nor presumably can amounts paid by the defendant to a private plaintiff under California Corporation Code section 25502 be used to reduce that defendant's 25502.5 liability. Whether multiple liability was indeed intended to remain in these non-SEC action situations is highly questionable; but the principle of *expressio unius est exclusio alterius*[54] would seemingly lead to the conclusion that such multiple liability potentially exists.

---

50. *Id.* § 25502.5(b).
51. *Id.*
52. *See supra*, note 46.
53. 15 U.S.C. § 78t-1 (1988).
54. "Specific inclusion of one thing in a statute implies the exclusion of others not mentioned." R. Kelso & C. Kelso, Studying Law: An Introduction 273 (1984). There is

V. Small Corporation Exclusion

The liability created by section 25502.5 is only applicable when the issuer whose securities were traded has "total assets in excess of one million dollars ($1,000,000) and . . . a class of equity security held of record by 500 or more persons."[55] The policy rationale for excluding smaller issuers from section 25502.5 presumably was the fear of unduly complicating the capitalization and sale of small enterprises. The specific exclusionary criteria raise some concern. The same criteria apply under section 12(g)(1) of the 1934 Securities Exchange Act[56] with regard to the registration with the S.E.C. of securities not registered on a national securities exchange under section 12(a) of that statute.[57] Unfortunately, that symmetry between section 25502.5(d) and section 12(g)(1) is illusory. Section 12(h)[58] in effect authorizes the Securities Exchange Commission to change the criteria of section 12(g)(1), and the S.E.C. has indeed exercised that power. Currently the section 12(g)(1) registration requirement, under Rule 12g-1,[59] only applies to issuers having more than *$5 million* in assets. It is, of course, possible that section 25502.5's reference to $1 million was made purposefully, i.e., to include within the section's scope issuers with more than $1 million but less than $5 million in assets. One cannot totally resist the thought, however, that this is just one more instance of problematic draftsmanship in a too hastily enacted piece of legislation. In similar instances the California legislature has previously attempted to maintain numerical symmetry between state and federal requirements. Thus, the eligibility requirement for statutory close corporation status was increased to thirty-five shareholders[60] when Congress adopted that numerical limitation

---

case authority holding that the *federal* law on insider trading does not permit the imposition of liability for the same transaction under both section 10(b) and section 16(b) of the 1934 Securities Exchange Act. National Westminster Bancorp NJ v. Leone, 702 F. Supp. 1132 (D.N.J. 1988).

55. Cal. Corp. Code § 25502.5(d). Prior drafts of section 25502.5 did not exempt small or closely held corporations. *See Review of Selected California Legislation*, 20 Pac. L.J. 423, 466 n.6 (1989).

56. 15 U.S.C. § 78l(g)(1) (1975).

57. 15 U.S.C. § 78l.

58. 15 U.S.C. § 78l(h).

59. 17 C.F.R. § 240.12g-1 (1988).

60. Cal. Corp. Code § 158(a) (West Supp. 1989).

in section 1361 of the Internal Revenue Code for S corporation tax status.[61]

VI. Utility of Issuer Recovery of Insider Trading Profits

The preceding ruminations have dealt with problems of draftsmanship. These can be solved by judicial interpretation and application of the statute in the years to come, unless it is amended to obviate such interpretive questions.

A perhaps more fundamental question remains. Is the creation of a statutory remedy to allow issuer recovery of insider trading profits a pragmatically useful remedy so that its utilization will be a meaningful deterrent to such trading activities? The crucial point here is that section 25502.5 recovery has a condition precedent attached to it—such recovery is based on the defendant's having violated section 25402. Proof of a section 25402 violation requires a showing of defendant's actual use of inside information. Ever since its enactment in 1968, section 25502 has given private plaintiffs who dealt with an "insider" a damage remedy for that insider's violation of section 25402. Yet no appellate case involving these two sections is referenced in the annotated California Corporation Code. No trial court level private suits involving these two sections seem to have ever been brought. In other words, section 25402 seems to have remained moribund. It is therefore highly unlikely that section 25502.5 will cause a change in that litigational void. It is difficult to escape the conclusion that California Corporation Code section 25502.5 was enacted in an emotional milieu influenced by the flurry of contemporaneous federal legislative activity caused by high-visibility misconduct on the part of the Wall Street professionals rather than by a detached analysis of the need for such legislation.

61. I.R.C. § 1361(b)(1) (West Supp. 1987).