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Commercial Transactions

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Commercial Transactions

Commercial Transactions; corporate securities

Corporations Code §§ 25102, 25104, 25113, 25608 (amended).
SB 115 (Beverly); 1993 STAT. Ch. 193

Under existing law, it is unlawful to offer or to sell¹ any security² in this state unless the security is qualified³ or exempt⁴ from qualification requirements.⁵ Existing law exempts any offer, but not sale, of a security,

1. See CAL. CORP. CODE § 25008 (West 1977) (specifying what constitutes an offer or sale of a security in California); *id.* § 25017 (West Supp. 1993) (defining offer, sale, and sell).

2. See *id.* § 25019 (West Supp. 1993) (defining security); see also CAL. GOV'T CODE § 5805 (West 1980) (defining a security, in the context of the sale of local government securities, as any bond, note, warrant, or other evidence of indebtedness issued in an aggregate principal amount of \$500,000 or more by any issuer, to finance a public project); *People v. Miller*, 192 Cal. App. 3d 1505, 1510-11, 238 Cal. Rptr. 168, 171 (1987) (classifying particular documents as securities under the risk capital test when money is raised for a business venture through indiscriminate offerings to members of the general public, who have no control over the success of the venture and whose money is substantially undersecured); *id.* (stating that the term security includes a promissory note secured by fractionalized interests in real property); *Leyva v. Superior Court*, 164 Cal. App. 3d 462, 470-74, 210 Cal. Rptr. 545, 549-52 (1985) (holding that the mere fact that a securities action was based in fraud did not require interpretation of fractional interests in promissory notes secured by trust deeds as "securities," within the meaning of the Corporations Code); *id.* (stating that it plainly was not the legislative intent that every note or evidence of indebtedness, regardless of its nature and of the circumstances surrounding its execution, be considered a security). See generally John Deacon & James D. Prendergast, *Defining a "Security" After the Foran Decision*, 11 PAC. L.J. 213, 213-33 (1980) (discussing the federal and California tests for defining securities); David Merritt Roberts, Comment, *The Definition of a Security Under the California Corporate Securities Law of 1968: The Risk Capital Test*, 6 PAC. L.J. 683, 702-03 (1975) (discussing the use of the risk capital test as a basis for defining a security and stating that the secured status of the investor is a crucial factor in that test).

3. See CAL. CORP. CODE §§ 25111-25113 (West 1977 & Supp. 1993) (establishing the qualification requirements for issuer and nonissuer transactions).

4. See *id.* §§ 25100-25105 (West 1977 & Supp. 1993) (specifying which securities and transactions are exempt from the qualification requirements of California Corporations Code §§ 25110 and 25130); see also 15 U.S.C. § 77d (1988) (listing the exempted transactions under the Securities Act of 1933).

5. CAL. CORP. CODE §§ 25110, 25130 (West 1977); see *id.* § 25110 (West 1977) (governing issuer transactions); *id.* § 25130 (West 1977) (governing nonissuer transactions); *People v. Figueroa*, 41 Cal. 3d 714, 722, 715 P.2d 680, 685, 224 Cal. Rptr. 719, 724 (1986) (stating that defendants, who were charged with the crime of selling unqualified securities, and who defended themselves on the basis that the securities were exempt, were not required to apply for and receive a formal exemption from the corporation's commissioner in order to sell the securities); *People v. Schock*, 152 Cal. App. 3d 379, 386, 199 Cal. Rptr. 327, 331 (1984) (stating that, under the Corporate Securities Law, in a situation where an investor receives adequate collateral, no risk capital is contributed to the managerial efforts of the promoter and, therefore, the business transaction does not qualify as a security transaction); cf. ARIZ. REV. STAT. ANN. § 44-1841 (Supp. 1993); ARK. CODE ANN. § 23-42-501 (Michie 1987); GA. CODE ANN. § 10-5-5 (Michie Supp. 1993); HAW. REV. STAT. § 485-8 (1985); KAN. STAT. ANN. § 17-1255 (1988); LA. REV. STAT. ANN. § 51:705 (West 1987); N.J. STAT. ANN. § 49:3-60 (West Supp. 1993); N.M. STAT. ANN. § 58-13B-20 (Michie 1991); N.C. GEN. STAT. § 78A-24 (1990); OR. REV. STAT. § 59.055 (1988); TEX. REV. CIV. STAT. ANN. art. 581-22 (West Supp. 1993) (requiring securities to be registered before they are offered or sold in each particular state, unless the securities or transactions are exempt from registration).

for which a registration statement⁶ under the federal Securities Act of 1933⁷ has been filed⁸ but has not yet become effective.⁹ Chapter 193 exempts any offer, but not a sale, of a security for which an offering

6. See 15 U.S.C. § 77b(8) (1988) (defining registration statement as the statement provided for in 15 U.S.C. § 77f, and including any amendment or any report, document, or memorandum filed as part of such statement or incorporated therein by reference); *id.* § 77aa (1988) (describing the information required to be included in the registration statement, such as: (1) General business and financial information regarding the business; (2) names, salaries, and financial interests of officers, directors, and underwriters of the business; and (3) financial information regarding the offering of the securities and the use of the proceeds); see also *id.* § 77f(a) (1988) (providing that any security may be registered with the Securities and Exchange Commission (SEC) by filing a registration statement).

7. See *id.* § 77a-77bbbb (1988 & Supp. II 1990) (comprising the Federal Securities Act of 1933).

8. See *id.* § 77f(c) (1988) (specifying when filing of the registration statement is deemed to have taken place).

9. CAL. CORP. CODE §§ 25102(b), 25104(g) (amended by Chapter 193); see 15 U.S.C. § 77h(a) (1988) (stating that the registration becomes effective on the twentieth day after filing the registration statement); *People v. Taylor*, 30 Cal. App. 3d 117, 123, 106 Cal. Rptr. 216, 219 (1973) (stating that, since a sale of securities had taken place, exemptions under Corporations Code §§ 25102(b) and 25104(g) are inapplicable, even if a valid registration statement under the Securities Act of 1933 was in existence); 2 BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS § 449.02(5)(a) (4th ed. 1993) (stating that an offer of a nonissuer security, but not a sale, is exempt from qualification, if a registration statement has been filed under the Securities Act of 1933); 1 MARSH & VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAW §§ 3.04, 10.03(7) (M. Bender rev. ed. 1993) (describing the exemption for any offer, but not a sale, of issuer and nonissuer securities for which a registration statement has been filed under the Securities Act of 1933); see also CAL. CORP. CODE § 25111(a) (West Supp. 1993) (providing that any security, for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offer, may be qualified by coordination under this section in an issuer or nonissuer transaction); *id.* § 25111(c) (West Supp. 1993) (providing that qualification of the sale of securities under this section automatically becomes effective, and the securities may be offered and sold, in accordance with the terms of the application, at the moment the federal registration statement becomes effective, if the required documents have been filed with the commissioner within the prescribed period); 2 BALLANTINE & STERLING, *supra*, §§ 453.01, 453.05 (stating that the simplest method of qualifying issuer and nonissuer securities for sale in California is when a registration statement under the Securities Act of 1933 has been filed with the Securities and Exchange Commission in connection with the same offering); 1 MARSH & VOLK, *supra*, §§ 6.03(1), 6.03(6) (stating that any security, for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offering, may be qualified by coordination and will become effective automatically when the registration statement is declared effective, as long as conditions regarding the relaying of certain documents to the commissioner are satisfied); cf. HAW. REV. STAT. § 485-6(12) (1985); NEV. REV. STAT. ANN. § 90.530(15)(a)-(c) (Michie Supp. 1991); OR. REV. STAT. § 50.035(11) (Supp. 1992); PA. STAT. ANN. tit. 70, § 1-203(h) (Supp. 1993); WASH. REV. CODE § 21.20.320(12) (Supp. 1993) (providing that any offer, but not a sale, of a security, for which registration statements have been filed under the Securities Act of 1933 and also with the appropriate state authorities, is an exempt transaction). See generally Walter G. Olson, *The California Corporate Securities Law of 1968*, 9 SANTA CLARA L. REV. 75, 80-94 (1968) (discussing California Corporate Securities Law procedures and requirements); William J. Woods, Comment, *California Corporate Securities Law: Small Business Capital Formation and Investor Protection*, 13 PAC. L.J. 459, 459-62 (1982) (discussing the need for small companies to raise equity capital more easily).

statement¹⁰ under Regulation A¹¹ of the Securities Act of 1933 has been filed but has not yet been qualified.¹²

Under existing law, all securities, whether eligible for qualification by coordination¹³ or notification,¹⁴ may be qualified by permit.¹⁵ In

10. See 57 Fed. Reg. 36,469 (1992) (to be codified at 17 C.F.R. § 230.252) (providing that the offering statement consists of Form 1-A, the contents required by the form, and any other material necessary to make the offering statement not misleading); 57 Fed. Reg. 36,476 (1992) (to be codified at 17 C.F.R. § 239.90) (requiring extensive disclosure of information regarding: (1) The operational and financial aspects of the business, the officers, agents, directors, and underwriters of the business; (2) the source, makeup and use of the security proceeds; and (3) a great deal of other information as well); see also FINANCING CALIFORNIA BUSINESSES § 7.90, at 374 (Cal. Continuing Educ. Bar 1976 & Update 1992) (stating that before commencement of the offering, an offering statement must be filed with the SEC in much the same manner as a registration statement in a registered offering).

11. See 57 Fed. Reg. 36,468 (1992) (to be codified at 17 C.F.R. §§ 230.251-230.363) (encompassing those sections of regulations that comprise Regulation A, which is a less cumbersome alternative for offering a small amount of securities to the public, while still complying with the requirement created by the Securities Act of 1933 that securities offered to the public be registered with the SEC); 2 BALLANTINE & STERLING, *supra* note 9, § 448.03 (discussing how Regulation A provides an exemption from the registration requirements of the Securities Act of 1933 for specified issuers when the total amount of cash, and other consideration, to be received for the securities does not exceed \$5 million); see also 15 U.S.C. §§ 77c(b), 77s(a) (1988) (granting the SEC the authority to create additional exemptions by rules and regulations, as long as they are in the public interest and the aggregate amount of the securities to be offered to the public does not exceed \$5 million); John M. Allen Jr., et al., *New Regulation Helps Small Businesses*, NAT'L L.J., Sept 21, 1992, at 17 (discussing the SEC raising of the Regulation A ceiling from \$1.5 to \$5 million to reduce the cost, and enhance the usefulness, of the Regulation A exception in helping small businesses raise capital). See generally FINANCING CALIFORNIA BUSINESSES, *supra* note 10, §§ 7.90-7.129, at 374-93 (outlining the entire Regulation A issuance and regulation process).

12. CAL. CORP. CODE §§ 25102(b), 25104(g) (amended by Chapter 193); see *id.* (exempting the transactions from the qualification requirements for issuer and nonissuer transactions); CAL. CODE REGS. tit. 10, § 260.105.29 (1990) (providing that any offer, but not sale, of a security, for which an offering statement under the Securities Act of 1933 has been filed with the SEC, and for which a qualification has been filed, is exempt from the qualification provisions of Corporations Code §§ 25110 and 25130); 2 BALLANTINE & STERLING, *supra* note 9, § 449.02(5)(b) (stating that an offering, but not a sale, which is exempt from registration under Regulation A, will be exempt from qualification under California law upon the filing of an offering statement with the SEC and an application for qualification with the State, because of Corporate Securities Rule § 260.105.29); 1 MARSH & VOLK, *supra* note 9, § 3.04(2) (declaring that, although the exemption from qualification is available only for offers subject to registration under the Securities Act of 1933, the commissioner has, by Rule 260.105.29, extended the same exemption to offers under Regulation A).

13. See CAL. CORP. CODE § 25111 (West Supp. 1993) (providing for qualification by coordination for issuer and nonissuer transactions).

14. See *id.* § 25112 (West 1977) (providing for qualification by notification for issuer transactions).

15. *Id.* § 25113(a) (West Supp. 1993); see *id.* § 25113(b)(1) (West Supp. 1993) (providing that an application for a permit must contain any information and must be accompanied by any documents required by rule of the Commissioner, in addition to information required by Corporations Code §§ 25160 and 25165); *id.* § 25160 (West 1977) (requiring an application for qualification to contain the following information: (1) The maximum amount of securities to be offered in California; (2) any adverse judgment, order, or decree entered in connection with the offering by the regulatory authority in any state or by any court or by the SEC; and (3) verification of the application; that if any material fact regarding the offering changes after filing the application for qualification, an amendment must be filed); *id.* § 25165 (West Supp. 1993) (requiring that every applicant for qualification of securities give irrevocable consent to service of process within California); CAL. CODE REGS. tit. 10, § 260.110 (1990) (mandating the content and form to be used for the application for qualification of securities); *id.* § 260.113 (1993) (outlining the required information and items to be submitted in an application

addition, existing law authorizes an applicant to file a Small Company Application for qualification of the sale of securities by permit if certain conditions are satisfied, one of which requires the applicant to file an undertaking with the Corporations Commissioner that there will be no stock splits,¹⁶ stock dividends,¹⁷ spinoffs,¹⁸ or mergers¹⁹ for a period of two years from the close of the offering.²⁰ Chapter 193 creates an

for qualification by permit); *People v. Baumgart*, 218 Cal. App. 3d 1207, 1222, 267 Cal. Rptr. 534, 542 (1990) (stating that the offense of selling securities without a permit is a strict liability offense); *People v. Park*, 87 Cal. App. 3d 550, 565, 151 Cal. Rptr. 146, 153 (1978) (stating that the main objective of the securities law is to protect the public against the imposition of insubstantial, unlawful, and fraudulent stock and investment schemes and to promote full disclosure of all information that is necessary to make informed and intelligent investment decisions).

16. See CAL. CORP. CODE § 188 (West 1990) (defining stock split as the pro rata division, other than by a share dividend, of all the outstanding shares of a class into a greater number of shares of the same class by an amendment to the articles stating the effect on outstanding shares); CAL. CODE REGS. tit. 10, § 260.103.2 (1990) (defining stock split, as used in § 25103(f), as the subdivision of previously outstanding shares of stock into a greater number of shares of the same class, effected by an amendment to the charter documents of the issuer); see also CAL. CORP. CODE § 25103(f) (West Supp. 1993) (outlining the stock splits or reverse stock splits that are exempt from qualification requirements).

17. See CAL. CODE REGS. tit. 10, § 260.017 (1990) (defining stock dividend as the issuance of additional shares, including treasury shares, of the issuer to its existing shareholders, without consideration other than the transfer from surplus to stated capital of an amount equal to or greater than the par, stated, or market value of the shares distributed, without any other consideration being paid by the shareholders, and not by an amendment to the articles of incorporation stating the effect on outstanding shares).

18. See SENATE RULES COMMITTEE, COMMITTEE ANALYSIS OF SB 115, at 1 (April 19, 1993) (defining a spinoff as a form of corporate divestiture that results in a subsidiary or division of the corporation becoming an independent company); see also FINANCING CALIFORNIA BUSINESSES, *supra* note 10, § 7.150, at 406 (stating that, in a spinoff, a public company distributes to its shareholders shares representing an interest in a private corporation, after which a public market is created through resales by the public company's shareholders); C. HUGH FRIEDMAN, CALIFORNIA PRACTICE GUIDE: CORPORATIONS, § 8:375 (The Rutter Group 1993) (stating that a spinoff occurs when a parent corporation distributes the stock of a subsidiary to its own shareholders pro rata as a dividend, resulting in those shareholders owning stock in two corporations).

19. See CAL. CORP. CODE §§ 1100-1112 (West 1990 & Supp. 1993) (authorizing and outlining the procedures and requirements for the merger of two or more corporations); *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 848, 120 Cal. Rptr. 556, 559 (1975) (stating that a merger signifies the absorption of one corporation by another which retains its name and corporate identity with the added capital, franchises, and powers of a merged corporation); ORGANIZING CORPORATIONS IN CALIFORNIA § 5.52, at 477 (Cal. Continuing Educ. Bar 1992) (stating that a merger is a transaction in which two or more constituent corporations are merged into the surviving corporation); FRIEDMAN, *supra* note 18, §§ 8:118.6, 8:161 (defining a merger as a reorganization in which one corporation is absorbed into another) *id.* (explaining that the surviving corporation receives all of the disappearing corporation's business, assets, and liabilities, and the shares of stock in the absorbed or disappearing corporation are converted into shares of stock or other securities of the survivor corporation); see also CAL. CORP. CODE § 161 (West 1990) (defining constituent corporation); *id.* § 181 (West 1990) (defining reorganization); *id.* § 190 (West 1990) (defining surviving corporation).

20. CAL. CORP. CODE §§ 25113(b)(2), 25113(b)(2)(C) (amended by Chapter 193); see *id.* § 25113(b)(2)(B) (amended by Chapter 193) (limiting the total offering of voting common stock that can be sold in a 12 month period to \$1 million and allowing only one class of voting common stock to be issued); CAL. CODE REGS. tit. 10, § 260.113.1 (1990) (detailing the rules and regulations to be followed when filing an application for qualification by permit under the Small Corporate Offering Registration (SCOR)); see also 2 BALLANTINE & STERLING, *supra* note 9, § 455.03 (outlining the requirements for a small company application for qualification by permit); FRIEDMAN, *supra* note 18, §§ 5:316.2 to .10, 1 MARSH & VOLK, *supra* note 9, §

exception by permitting the Commissioner to approve a spinoff or merger pursuant to an application for qualification²¹ filed by an applicant.²²

FSG

Commercial Transactions; corporations—securities

Corporations Code §§ 25110, 25540, 25541 (amended).
SB 955 (Presley); 1993 STAT. Ch. 762

Corporations Code § 25403 (new).
AB 1160 (Caldera); 1993 STAT. Ch. 723
(Effective October 4, 1993)

Under existing law, it is unlawful to offer or to sell¹ any security² in

6.05(5), at 6-22.1 (discussing the requirements for a small company application for qualification by permit and stating that the purpose of this provision is to reduce the cost of preparing the required disclosure by allowing the applicant to use the simpler question and answer format of Form U-7 of the North American Securities Administrators Association); cf. ARIZ. REV. STAT. ANN. § 44-1902 (1992); IND. CODE ANN. § 23-2-1-5.5 (Burns 1992); IOWA CODE § 502.207A (1992) (providing for the registration, by qualification, of small companies issuing less than \$1 million in securities and authorizing the commissioner to issue rules and regulations to implement this program). See generally Bruce Dravis, *State Shortchanging Small-Business Capital Formation*, SACRAMENTO BEE, Apr. 11, 1993, at G2 (stating that, on March 1, 1993, the California Department of Corporations issued its regulations on the use of the short-form Small Corporate Offering Registration for offerings of securities of up to \$1 million, but the new regulations render SCOR all but unusable in California by imposing conditions so extensive and costly as to undermine it as an economical alternative to a registered public offering); John R. Emshwiller, *SCOR Funding Provides Short Form for Going Public: Process Helps Small Firms Tap Markets With Less Difficulty and Expense*, WALL ST. J., Jan. 21, 1992, at B2 (stating that SCOR was created in the late 1980's by government regulators and securities attorneys to enable small companies to go public with less difficulty and expense than a traditional securities offering usually involves, and is now available in 21 states); Tom Petruno, *This Is a Good Idea if the Risks Can Be Controlled*, L.A. TIMES, Jan. 24, 1992, at D3 (discussing SCOR's allowance of a qualifying small company to raise up to \$1 million by selling stock directly to individual investors, avoiding the expense of a brokerage underwriter and the red tape of the federal Securities and Exchange Commission's stock-approval process, and leaving it up to state regulators to screen their own companies and decide which ones can and cannot sell stock).

21. See CAL. CORP. CODE § 25121 (West 1977) (providing for an application for qualification by permit for securities to be offered or sold in connection with a recapitalization or reorganization); see also *id.* § 25120 (West Supp. 1993) (specifying that it is necessary to qualify securities, or the securities must be exempt, in order to offer or sell securities in connection with a merger, consolidation, recapitalization, or purchase of assets, if using consideration based wholly or in part on the issuance of securities); CAL. CODE REGS. tit. 10, § 260.121 (1990) (mandating the contents and forms used for the application for qualification by permit of securities involved in a recapitalization or reorganization).

22. CAL. CORP. CODE § 25113(b)(2)(C) (amended by Chapter 193).

1. See CAL. CORP. CODE § 25008 (West 1977) (specifying what constitutes an offer or sale of a security in this state); *id.* § 25017 (West Supp. 1993) (defining offer, sale, and sell).

this state unless the security is either qualified³ or exempt⁴ from qualification requirements.⁵ Chapter 762 provides that the offer or sale of a qualified or exempt security, in a manner that varies or differs from, exceeds the scope of, or fails to conform with, either a material⁶ term or

2. See *id.* § 25019 (West Supp. 1993) (defining security); CAL. GOV'T CODE § 5805 (West 1980) (defining a security, in the context of the sale of a local government securities, as any bond, note, warrant, or other evidence of indebtedness issued in an aggregate principal amount of \$500,000 or more by any issuer to finance a public project); *People v. Miller*, 192 Cal. App. 3d 1505, 1510-11, 238 Cal. Rptr. 168, 171 (1987) (classifying particular documents as securities under the risk capital test when money is raised for a business venture through indiscriminate offerings to members of the general public, who have no control over the success of the venture and whose money is substantially undersecured); *id.* (stating that the term security includes a promissory note secured by fractionalized interests in real property); *Leyva v. Superior Court*, 164 Cal. App. 3d 462, 470-74, 210 Cal. Rptr. 545, 549-52 (1985) (holding that the mere fact that a securities action was based in fraud did not require interpretation of fractional interests in promissory notes secured by trust deeds as securities, within the meaning of the Corporations Code); *id.* (stating that it plainly was not the legislative intent that every note or evidence of indebtedness, regardless of its nature and of the circumstances surrounding its execution, be considered a security); 2 BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS §§ 444.01-444.02 (R. Bradbury Clark ed., 4th ed. 1993) (explaining the statutory definition of the term security and the legal tests used by the courts to determine whether a financial instrument or contract is a security); C. HUGH FRIEDMAN, CALIFORNIA PRACTICE GUIDE: CORPORATIONS § 5:195.3 (The Rutter Group 1993) (discussing factors considered and the tests used in determining what is a security and stating that, in criminal cases, the jury must decide whether a security exists). See generally John Deacon & James D. Prendergast, *Defining a "Security" After the Forman Decision*, 11 PAC. L.J. 213, 213-33 (1980) (discussing the federal and California tests for defining securities); David Merritt Roberts, Comment, *The Definition of a Security Under the California Corporate Securities Law of 1968: The Risk Capital Test*, 6 PAC. L.J. 683, 702-03 (1975) (discussing the use of the risk capital test as a basis for defining a security and stating that the secured status of the investor is a crucial factor in that test).

3. See CAL. CORP. CODE §§ 25111-25113 (West 1977 & Supp. 1993) (establishing the requirements for the qualification of security transactions by coordination, notification, and permit).

4. See *id.* §§ 25100-25105 (West 1977 & Supp. 1993) (specifying which securities and transactions are exempt from the qualification requirements of California Corporations Code §§ 25110 and 25130); see also 15 U.S.C. § 77d (1988) (listing the exempted transactions under the Securities Act of 1933).

5. CAL. CORP. CODE §§ 25110, 25130 (West 1977 & amended by Chapter 762); see *id.* § 25110 (amended by Chapter 762) (governing issuer transactions); *id.* § 25130 (West 1977) (governing nonissuer transactions); *People v. Figueroa*, 41 Cal. 3d 714, 722, 715 P.2d 680, 685, 224 Cal. Rptr. 719, 724 (1986) (stating that defendants, who were charged with the crime of selling unqualified securities and defended themselves on the basis that the securities were exempt, were not required to apply for and receive a formal exemption from the corporations commissioner in order to sell the securities); *People v. Schock*, 152 Cal. App. 3d 379, 386, 199 Cal. Rptr. 327, 331 (1984) (stating that, under the Corporate Securities Law, in a situation where an investor receives adequate collateral, no risk capital is contributed to the managerial efforts of the promoter and, therefore, the business transaction does not qualify as a security transaction); cf. ARIZ. REV. STAT. ANN. § 44-1841 (Supp. 1993); ARK. CODE ANN. § 23-42-501 (Michie 1987); GA. CODE ANN. § 10-5-5 (Michie Supp. 1993); HAW. REV. STAT. § 485-8 (1985); KAN. STAT. ANN. § 17-1255 (1988); LA. REV. STAT. ANN. § 51:705 (West 1987); N.J. STAT. ANN. § 49:3-60 (West Supp. 1993); N.M. STAT. ANN. § 58-13B-20 (Michie 1991); N.C. GEN. STAT. § 78A-24 (1990); OR. REV. STAT. § 59.055 (1988); TEX. REV. CIV. STAT. ANN., art. 581-22 (West Supp. 1993) (requiring securities to be registered before they are offered or sold in their particular state, unless the securities or transactions are exempt from registration).

6. See *In re Keegan Management Co., Securities Litigation*, 794 F. Supp. 939, 945 (N.D. Cal. 1992) (stating that, in determining whether information allegedly omitted from a prospectus issued pursuant to an initial public offering of stock was material, the court must do more than determine materiality of each specific fact; the court must also determine the materiality of inferences which may be properly drawn from the facts as a whole); *Insurance Underwriters Clearinghouse, Inc. v. Natomas Co.*, 184 Cal. App. 3d 1520, 1526, 228 Cal.

material condition of qualification of the offering, as set forth in the permit or qualification order, or a material representation as to the manner of offering which is set forth in the application for qualification, must be an unqualified offer or sale.⁷

Prior law provided that any person who willfully⁸ violated a provision, rule, or order under the Corporate Securities Law of 1968⁹ had to be fined not more than \$250,000 upon conviction.¹⁰ Chapter 762 increases the

Rptr. 449, 453 (1986) (providing that, under the Federal Securities Act of 1933, a fact is material if there is a substantial likelihood that, under all the circumstances, a reasonable investor would consider it important in reaching an investment decision, and stating that this test of materiality is the same under the California Corporations Code); *see also* 1 MARSH & VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAW § 14.03(2)(b) (M. Bender rev. ed. 1993) (stating that a material fact, in a civil securities case, has been defined by the federal courts as a fact which would influence the judgment or decision of the other party to the transaction, and stating that the standard of materiality under the California Corporate Securities Law has been held to be the same as the federal standard).

7. CAL. CORP. CODE § 25110 (amended by Chapter 762); *see id.* § 25141 (West 1977) (authorizing the commissioner to impose conditions upon the qualification of securities); *id.* § 25166 (West 1977) (providing that it is unlawful for any person to willfully make any untrue statement of a material fact in any application, notice, or report filed with the commissioner in connection with the qualification of a security, or to willfully omit to state in any such application, notice, or report any material fact which is required to be stated therein); *see also* 2 BALLANTINE & STERLING, *supra* note 2, § 466.02(1) (stating that a person who sells securities without a permit is also subject to criminal prosecution and may be ordered, as a condition of probation, to pay restitution to the purchasers of the securities).

8. *See People v. Baumgart*, 218 Cal. App. 3d 1207, 1219, 267 Cal. Rptr. 534, 540 (1990) (defining willfully, in the context of a violation of Corporations Code § 25540, as simply meaning a purpose or willingness to commit the act or make the omission referred to and not requiring any intent to violate the law, to injure another, or to acquire any advantage); *Baumgart*, 218 Cal. App. 3d at 1217-1222, 267 Cal. Rptr. at 539-542 (holding that the use of false statements in the sale of securities and the selling of securities without a permit are strict liability offenses); *People v. Gonda*, 138 Cal. App. 3d 774, 779, 188 Cal. Rptr. 295, 297 (1982) (stating that the courts have consistently held that, even where the statute requires a willful violation, public welfare offenses, in general, are punishable without proof of criminal intent); *People v. Clem*, 39 Cal. App. 3d 539, 542, 114 Cal. Rptr. 359, 361 (1974) (stating that the Legislature intended Corporations Code § 25540 to preserve strict criminal liability for violations of the Corporate Securities Law).

9. *See id.* §§ 25000-25706 (West 1977 & Supp. 1993) (encompassing the California Securities Law of 1968).

10. 1988 Cal. Stat. ch. 1339, sec. 5, at 4431 (amending CAL. CORP. CODE § 25540); 1988 Cal. Stat. ch. 1339, sec. 6, at 4431 (amending CAL. CORP. CODE § 25541); *see* CAL. CORP. CODE § 25540(a) (amended by Chapter 762) (providing that it is unlawful for any person to willfully violate any provision, rule, or order of the California Corporate Securities Law of 1968); *id.* § 25540(b) (amended by Chapter 762) (providing that it is unlawful for any person to willfully violate Corporations Code §§ 25400-25402); *id.* § 25541 (amended by Chapter 762) (providing that it is unlawful for any person to: (1) Willfully employ any device, scheme, or artifice to, defraud in connection with the offer, purchase, or sale of any security; or (2) willfully engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person with the offer, purchase, or sale of any security); *see also id.* § 25400 (West 1977) (providing that it is unlawful to commit acts or misrepresentations to induce the purchase or sale of securities or to manipulate their price); *id.* § 25401 (West 1977) (specifying that it is unlawful to sell or purchase securities by means of written or oral communications containing false statements or omissions); *id.* § 25402 (West 1977) (providing that it is unlawful for a person to purchase or sell securities while having access to material information not available to the public and known through a special relationship with the issuer); 2 BALLANTINE & STERLING, *supra* note 2, §§ 466.01(2), 466.03 (discussing criminal liability for security law violations and in particular, the offense of misrepresentation or omission of a material fact in connection with the offer, sale, or purchase of securities); 1

possible fines that may be imposed to \$1,000,000 in most instances and up to \$10,000,000 in specific circumstances.¹¹

Chapter 723 makes it unlawful for any person¹² to offer or sell any security constituting a fractional interest in a lease,¹³ installment sale,¹⁴ or other obligation of a city, county, city and county, school, special district,¹⁵ or other local agency¹⁶ of this state without obtaining the prior written consent of that agency for that offer or sale, except as specified.¹⁷

MARSH & VOLK, *supra* note 6, § 14.13(1)-(2) (discussing the criminal penalties that may be imposed for willful violation of securities laws and for fraud under Corporations Code § 25541).

11. CAL. CORP. CODE §§ 25540-25541 (amended by Chapter 762); *see id.* § 25540(a) (amended by Chapter 762) (increasing the amount of the allowable fine from \$250,000 to \$1,000,000 for violation of the California Corporate Securities Law of 1968, Corporations Code §§ 25000-706); *id.* §§ 25540(b), 25541 (amended by Chapter 762) (increasing the amount of the allowable fine from \$250,000 to \$10,000,000 for violation of California Corporations Code §§ 25400, 25401, 25402, 25403, or 25541).

12. *See* CAL. CORP. CODE § 25013 (West Supp. 1993) (defining person).

13. *See* CAL. COM. CODE § 10103 (West Supp. 1993) (defining lease as a transfer of the right to possession and use of goods for a term in return for consideration).

14. *See* BLACK'S LAW DICTIONARY 799 (6th ed. 1990) (defining installment sale as a commercial arrangement in which the buyer makes an initial down payment and signs a contract for payment of the balance in installments over a period of time).

15. *See* CAL. GOV'T CODE § 56036 (West Supp. 1993) (defining special district to mean an agency of the state, formed pursuant to general law or special act, for the local performance of governmental or proprietary functions within limited boundaries, which includes a county service area, but excludes the state, a county, a city, a school district or community college district, a special assessment district, and other enumerated districts of various types).

16. *See id.* § 53570(a) (West Supp. 1993) (defining local agency as a public district, public corporation, authority, agency, board, commission, county, city and county, city, school district, any other public entity, or any improvement district or zone thereof).

17. CAL. CORP. CODE § 25403 (enacted by Chapter 723); *see id.* (allowing the following securities and transactions to be exempt from the application of this section: (1) Offers and sales of shares or interests in any registered unit, investment trust or management company, as defined by Section 4 of the Federal Investment Company Act of 1940 (15 U.S.C. § 80a-4); (2) offers and sales of any security described in this section that has previously been offered or sold in compliance with this section; and (3) offers and sales of participation interests between financial institutions); *id.* (specifying that obtaining prior written consent does not obviate the necessity of qualifying the offer or sale of any security constituting a fractional interest, unless the security or transaction is exempt from qualification under the Corporate Securities Law); Patrice Hill, *Los Angeles County to Push for a Bill to Combat Problem Vendor Lease Deals*, BOND BUYER, Nov. 19, 1992, at 1 (explaining that, in 1991, when Los Angeles County tried to market its own equipment lease securities, it unexpectedly ran into a vendor offering similar county equipment lease securities, which caused the county to delay its offering, cost the county an additional \$200,000 in higher interest expense, and provoked it into pushing for legislation making the sale of any fractionalized interest in a California municipal obligation, without the consent of the government, a state securities law violation); *see also* CAL. GOV'T CODE § 54241 (West 1983) (forbidding local agencies from entering into a public leaseback of more than five years without passing an enabling ordinance, and subjecting the agencies to a referendum, if required for ordinances adopted by the agency); *id.* § 5807 (West 1980) (defining public leaseback as any lease by a public body of all or any part of a public project where the lease is between the public body, as lessee, and an issuer, as lessor, and the lease is executed before the public project is acquired, constructed, or completed); OFFICE OF PLANNING & RESEARCH, STATE OF CALIFORNIA, *PAYING THE PIPER: NEW WAYS TO PAY FOR PUBLIC INFRASTRUCTURE IN CALIFORNIA* (1982) (discussing alternative municipal financing techniques, such as lease purchase agreements and sale-leasebacks of existing municipal facilities, and the importance of breaking up the lease into smaller shares through an offering of certificates of participation, which make the offering more attractive to investors). *See generally* Janice E. Kosel, *Municipal*

In addition, Chapter 762 provides that a willful violation of the above provisions will be a crime, punishable by a fine not exceeding \$10,000,000, imprisonment for two, three, or five years, or both.¹⁸

FSG

Commercial Transactions; false financial statements

Penal Code § 532f (new).

AB 1231 (Umberg); 1993 STAT. Ch. 482

Under existing law, any person¹ who knowingly² makes, benefits from, or reaffirms any false statement in writing, with the intent³ that it be relied upon with respect to a person's or entity's⁴ financial condition or ability to pay, for the purpose of obtaining the delivery of personal

Debt Limitation in California, 7 GOLDEN GATE U. L. REV. 641, 649-54 (1977) (discussing lease-purchase financing as a means of evading debt limitations on local and state governments and agencies); Debora Vrana, *L.A. County Diverts Marina del Rey Revenue to Balance Budget for Year*, L.A. BUS. J., May 31, 1993, at 4 (describing Los Angeles County's selling of \$133 million of tax-exempt certificates of participation in Marina del Rey, thus diverting 14 years of revenue from the county to the certificate holders); *id.* (quoting Zane B. Mann, publisher of the *California Municipal Bond Advisor*, who stated, "It's certainly not good government policy to mortgage an existing facility to pay a budget shortfall" and "certificates of participation were supposed to be used when you went to build a new school, not to take something you already own and put a hook in it").

18. CAL. CORP. CODE § 25540(b) (amended by Chapter 762); *see* *People v. Feno*, 154 Cal. App. 3d 719, 725, 201 Cal. Rptr. 513, 515-16 (1984) (holding that a violation of California Corporations Code § 25110, which covers the unqualified sale of nonexempt securities, is a strict liability offense when punished under California Corporations Code § 25540); *People v. Clem*, 39 Cal. App. 3d 539, 542-43, 114 Cal. Rptr. 359, 361 (1974) (holding that obtaining advice of counsel, or any other evidence of good faith, is not a defense to a charge of dealing in unqualified securities, unless it consists of reliance upon an opinion of the Commissioner or Attorney General, since a willful violation only requires proof that the person acted intentionally in the sense that the person was aware of what he was doing, not proof of evil motive or knowledge that the law was being violated).

1. *See* CAL. PENAL CODE § 7 (West 1988) (defining person).

2. *See id.* § 7(5) (West 1988) (defining knowingly as importing only a knowledge that facts exist which bring the act or omission within the provisions of the code and not requiring any knowledge of the unlawfulness of such an act or omission).

3. *See id.* § 21 (West 1988) (stating that intent is manifested by the circumstances connected with the offense); *see also* *People v. Ashley*, 42 Cal. 2d 246, 264, 267 P.2d 271, 282 (1964) (stating that, in cases where property has been obtained by false pretenses, it must be proven that any misrepresentation of fact alleged was made knowingly and with the intent to deceive); *Otash v. Bureau of Private Investigators and Adjusters*, 230 Cal. App. 2d 568, 572, 41 Cal. Rptr. 263, 267 (1964) (stating that, to sustain a conviction for conspiracy to defraud and obtain money by false pretenses, it must be established that the defendants intended to commit fraudulent acts).

4. *See* CAL. PENAL CODE § 532a(1)-(3) (West 1988) (providing that the false statement may be made regarding the financial condition or ability to pay of the defendant, or any other person, firm, or corporation, in which the defendant is interested or for whom the defendant is acting)

property,⁵ the payment of cash, the making of a loan or credit, or the extension of credit, is guilty of a public offense.⁶ Chapter 482 provides that any person, other than the loan applicant, who commits the above public offense in connection with an application for a loan secured by real property⁷ is guilty of a misdemeanor punishable by up to one year imprisonment in a county jail, a fine not to exceed \$10,000, or both.⁸ In

5. See *id.* § 7(12) (West 1988) (defining personal property as including money, goods, chattels, choses in action, and evidences of debt).

6. *Id.* § 532a(1)-(3) (West 1988); see *id.* (providing that the false statement may be made directly, indirectly, or through an agency); *id.* (including the execution of a contract of guaranty or suretyship; the discount of an account receivable; or the making, acceptance, discount, sale, or endorsement of a bill of exchange or promissory note among the transactions that are covered by this section); *id.* § 532a(4) (West 1988) (providing that any person violating this section will be guilty of a misdemeanor, punishable by a fine of up to \$1,000, up to six months imprisonment in the county jail, or both); *People v. Breyer*, 139 Cal. App. 547, 550, 34 P.2d 1065, 1066 (1934) (holding that where Penal Code § 484, under which the crimes of larceny, embezzlement, and obtaining money by false pretenses are merged into the one crime of grand theft, conflicts with Penal Code § 532a, the latter statute is superseded); *People v. Barnard*, 63 Cal. App. 562, 571, 219 P. 756, 760 (1923) (stating that where the punishment of a crime, as in the case of larceny or the obtaining of money or property by false pretenses, is made to depend upon the value of the money or property taken or obtained, the value must be stated in the indictment); see also CAL. PENAL CODE § 15 (West 1988) (defining public offense); *id.* § 17 (West Supp. 1993) (defining misdemeanor); *id.* § 19.2 (West Supp. 1993) (outlining the allowable punishment for a misdemeanor); *id.* § 19.4 (West Supp. 1993) (declaring that, when a statute declares an act or omission a public offense, and no penalty is given in the statute, it is punishable as a misdemeanor); cf. 18 U.S.C. § 2113(b) (1988) (providing that anyone who takes, with intent to steal or purloin, any property or money or thing of value from a bank or similar institution, is guilty of a crime); ALA. CODE § 13A-9-49 (1992); FLA. STAT. ch. 817.03 (1992); KY. REV. STAT. ANN. § 517.090 (Baldwin 1993); MASS. ANN. LAWS ch. 266, § 33 (Law Co-op. 1993); MICH. COMP. LAWS § 750.219 (1991); OR. REV. STAT. § 165.100 (1991); R.I. GEN. LAWS § 11-18-6 (1992); TENN. CODE ANN. § 39-14-120 (1992); UTAH CODE ANN. § 76-6-517 (1992); WYO. STAT. § 6-3-612 (1992); V.I. CODE ANN. tit. 9, § 128 (1992) (providing statutes for punishment of false written statements to obtain property or credit); MASS. ANN. LAWS ch. 266, § 34 (Law Co-op. 1993); N.Y. PENAL LAW § 155.05 (Consol. 1993); 18 PA. CONS. STAT. § 3922 (1992); VA. CODE ANN. § 18.2-178 (Michie 1992); W. VA. CODE § 61-3-24 (1992) (outlining the general purpose false pretenses statutes regarding the obtaining of money, property, or services); *United States v. Shoels*, 685 F.2d 379, 382-83 (10th Cir. 1982) (holding that 18 U.S.C. § 2113(b) is not limited to common-law larceny and, thus, encompasses conduct which was in the nature of false pretenses); *Commonwealth v. Stovall*, 498 N.E.2d 126, 129 (App. Ct. Mass. 1986) (stating that larceny by false pretenses may be based upon the obtaining of a loan, and neither the intent to repay the loan obtained by false pretenses, nor actual payment, negates criminality); *State v. Rogers*, 554 A.2d 866, 866 (N.J. Super. Ct. App. Div. 1989) (holding that obtaining loans based on falsification of documents and misrepresentation constitutes theft by deception). See generally SENATE COMMITTEE ON JUDICIARY, COMMITTEE ANALYSIS OF AB 1231, at 2-3 (July 13, 1993) (discussing that California mortgages accounted for 58% of all fraud-related mortgage claims made nationally, even though only 14% of the business was in California, which is leading to increased costs incurred by lenders for the screening of loan applications, and resulting in those increased costs being passed on to California consumers in higher loan fees); George Caras, Note, *Criminal Law—Larceny—The Distinctions Between Larceny and False Pretenses*, 25 S. CAL. L. REV. 367, 367-69 (1952) (discussing the differences between larceny and false pretenses); Richard L. Weatherspoon, Note, *False Pretenses: Obtaining Contractual Obligation by Fraudulent Representations as Criminal Offense*, 12 HASTINGS L.J. 321, 324-25 (1961) (discussing the California statutes dealing with false pretenses and their interrelationship).

7. See CAL. PENAL CODE § 7(11) (West 1988) (defining real property as being coextensive with lands, tenements, and hereditaments).

8. *Id.* § 532f(a)(1) (enacted by Chapter 482).

addition, Chapter 482 requires the court to determine the amount of any economic loss to a victim caused by the criminal conduct of the defendant and, to the extent possible, order the defendant to make restitution⁹ to the victim in that amount.¹⁰ In the case where the above offense is committed by the loan applicant, the misdemeanor is punishable by up to six months imprisonment, a fine not to exceed \$10,000, or both.¹¹

FSG

Commercial Transactions; impaired or insolvent insurers; dividends

Insurance Code §§ 1067.02, 1067.04, 1067.18 (amended).
SB 435 (Russell); 1993 STAT. Ch. 975

Insurance Code §§ 1066, 1066.1, 1066.2, 1066.3, 1066.4, 1066.5, 1066.6, 1066.7, 1066.8, 1066.9, 1066.10, 1066.11, 1066.12, 1066.13, 1066.14, 1066.15, 1066.16, 1066.17, 1066.18, 3010, 3013.5, 3014, 3015, 3016, 3017, 12465 (repealed); §§ 1067, 1067.02, 1067.03, 1067.04, 1067.05, 1067.06, 1067.07, 1067.08, 1067.09, 1067.10, 1067.11, 1067.12, 1067.13, 1067.14, 1067.15, 1067.16, 1067.17, 1067.18 (repealed and new); §§ 10550, 10552, 10553, 10555, 10556, 10557, 10558, 10559, 10560, 10561, 10562, 10563 (new); §§ 1021, 1025.5, 1033, 1033.5, 1152, 1215, 1215.4, 1215.5, 10530 (amended).
SB 482 (Johnston); 1993 STAT. Ch. 974

Under prior law, life insurers who were unable to pay life insurance claims obtained coverage from the California Life Insurance Guaranty

9. See *id.* § 1203.04(d) (West Supp. 1993) (defining restitution as full or partial payment for the value of stolen or damaged property, medical expenses, and wages or profits lost due to injury, time spent as a witness, or in assisting the police or prosecution, resulting from the defendant's commission of the crime for which he was convicted); see also *id.* § 1203.04(a) (West Supp. 1993) (requiring that the court order the defendant to make restitution to either the victim or the Restitution Fund, in every case where a person is convicted of a crime and is granted probation).

10. *Id.* § 532f(a)(2) (enacted by Chapter 482); see *id.* (specifying that restitution is applicable to a violation of Penal Code § 532a only to a person other than the loan applicant).

11. *Id.* § 532f(b) (enacted by Chapter 482).

Association.¹ Prior law, specifically the Robbins-Seastrand Health Insurance Guaranty Association Act,² had similar provisions for insurers unable to pay claims under health and supplemental policies or contracts due to insolvency³ or impairment.⁴ Chapter 974 replaces both entities with the California Life and Health Insurance Guarantee Association (CLHIGA).⁵ Chapters 974 and 975 also assign to CLHIGA the task of supplying coverage in direct, nongroup life, health, annuity,⁶ and supplemental policies⁷ or contracts of insurance should a member insurer suffer impairment or insolvency, and thereby fail to execute the requisite contractual obligations⁸ under the policies.⁹ Chapter 974 delineates not

1. 1992 Cal. Stat. ch. 956, sec. 9, at 3921-22 (amending CAL. INS. CODE § 1067.07(a)-(c)); see 1 CAL. INSURANCE LAW & PRAC. § 7.13[1]-[9] (Matthew Bender ed. 1993) (providing an extensive overview of the powers, policies, services, and administration of the California Life Insurance Guaranty Association). See generally CAL. INS. CODE § 1063 (West 1993) (establishing the California Insurance Guaranty Association); *Phoenix Ins. Co. v. United States Fire Ins. Co.*, 189 Cal. App. 3d 1511, 1517 n.1, 235 Cal. Rptr. 185, 186 n.1 (1987) (interpreting the purpose of the California Insurance Guaranty Association to be the provision of coverage against loss that stems from the insolvency of an insurer); 39 CAL. JUR., *Insurance Companies* § 169 (1977) (discussing the California Insurance Guaranty Association).

2. 1990 Cal. Stat. ch. 1246, sec. 1, at 4498 (enacting CAL. INS. CODE § 1066); see 1 CAL. INSURANCE LAW & PRAC., *supra* note 1, at § 7.12[1]-[9] (providing an extensive overview of the powers, policies, services, and administration of the California Health Insurance Guaranty Association).

3. See CAL. INS. CODE § 985(a) (West 1993) (defining insolvency as any impairment of minimum paid-in capital or capital paid-in required in the aggregate of an insurer); see also 1 CAL. INSURANCE LAW & PRAC., *supra* note 1, at § 7.03[2] (discussing insolvency of insurers).

4. 1992 Cal. Stat. ch. 956, sec. 7, at 3918 (amending CAL. INS. CODE § 1066.7(a)-(c)); see CAL. INS. CODE § 988(a)(1) (West Supp. 1993) (defining impairment as a financial situation in which the assets of an insurer are less than the sum of the insurer's minimum required capital, minimum required surpluses, and all liabilities); see also 1 CAL. INSURANCE LAW & PRAC., *supra* note 1, at § 7.03[1] (discussing impairment of insurers).

5. CAL. INS. CODE § 1067.05(a) (repealed and enacted by Chapter 974); see *id.* § 1067.01(a) (repealed and enacted by Chapter 974) (setting forth the purpose of the new provisions as being a protective shield against failure by life and health insurance providers in the performance of contractual obligations); SENATE FLOOR ANALYSIS OF SB 482, at 2 (May 20, 1993) (noting that Chapter 974 is the final piece of legislation required for California to be accredited by the National Association of Insurance Commissioners); *id.* (observing that failure to obtain certification would hamper the state's ability to conduct business in other states); see also ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 81 (1987) (providing a brief look at the NAIC). See generally Adam Hodkin, Note, *Insurer Insolvency: Problems & Solutions*, 20 HOFSTRA L. REV. 727, 728-48 (1992) (tracing the different practices of state regulatory agencies in rehabilitating or liquidating insolvent insurers); *Insolvent Insurer Banned from California*, L.A. TIMES, June 17, 1993, at D2 (reporting on Insurance Commissioner John Garamendi's decision to bar unlicensed Western Star Insurance Co. from selling insurance in the state because of the firm's insolvency).

6. See Jerry, *supra* note 5, at § 13A[3] (defining and discussing annuities); Arthur Allen Leff, *The Leff Dictionary of Law: A Fragment*, 94 YALE L.J. 1855, 2028-29 (1985) (defining the definition of annuity).

7. See CAL. INS. CODE § 1067.04(m) (repealed and enacted by Chapter 974, and amended by Chapter 975) (defining supplementary contract).

8. See *id.* § 1067.04(d) (repealed and enacted by Chapter 974, and amended by Chapter 975) (defining contractual obligation).

9. *Id.* § 1067.02(b)(1) (repealed and enacted by Chapter 974, and amended by Chapter 975).

only the duties and powers of CLHIGA, but also the procedures for claim payments.¹⁰

Existing law limits domestic¹¹ stock insurers to making dividends from the surplus¹² of admitted assets¹³ in excess of the aggregate of either par value of issued or subscribed shares, a surplus based on par value of issued or subscribed shares, or specified reserves.¹⁴ Chapter 974 instead indicates that only earned surplus¹⁵ can be a source of dividends, unless certain exceptions apply.¹⁶

Under Chapter 974, insurers registered under the Holding Company Act¹⁷ become obligated to prohibit the payment of dividends until ten days have elapsed following notification to the Insurance Commissioner.¹⁸ Chapter 974 empowers the Commissioner to stop the payment of a dividend by issuing an order, if prompted by a belief that the payment may be in violation of the Insurance Code or may pose a hazard to the insurer's policyholders, creditors, or the public.¹⁹ In the process of determining the

10. *Id.* §§ 1067.07-1067.17 (repealed and enacted by Chapter 974); *see, e.g., id.* § 1067.07(a)(1) (repealed and enacted by Chapter 974) (authorizing the association to guarantee, assure, or reinsure policies of an impaired insurer); *id.* § 1067.07(a)(2) (repealed and amended by Chapter 974) (empowering the association to allot monies, pledges, or notes as coverage for the insurer); *id.* § 1067.07(a)(3) (repealed and enacted by Chapter 974) (designating the association as a source for monetary loans).

11. *See id.* § 26 (West 1993) (defining domestic).

12. *See* MODEL BUSINESS CORP. ACT § 2(k) (Supp. 1977) (defining surplus); George C. Seward, *Earned Surplus — Its Meaning and Use in the Model Business Corporation Act*, 38 VA. L. REV. 435, 437 (1952) (delineating two components of surplus: capital surplus and earned surplus); *see also* 19 HARRY GOLTER, FLETCHER CYCLOPEDIA CORP. § 4:34 (1988) (defining surplus).

13. *See* Leff, *supra* note 6, at 1947 (defining admitted assets).

14. CAL. INS. CODE § 1152 (amended by Chapter 974); *see* Golter, *supra* note 12, at § 4:50 (explaining the purpose of accumulated surplus).

15. *See* MODEL BUSINESS CORP. ACT § 2(1) (Supp. 1977) (defining earned surplus); Golter, *supra* note 12, at § 4:34 (1988) (defining earned surplus); *id.* § 4:48 (distinguishing between paid-in surplus and earned surplus).

16. CAL. INS. CODE § 1152(a) (amended by Chapter 974); *see id.* § 1152(c) (amended by Chapter 974) (exempting insurers from the prohibitions of this section if: (1) After dividends have been paid, an insurer's surplus as regards policyholders is reasonable and adequate in relation to its liabilities; and (2) approval has been obtained from the insurance commissioner); *see also* LARRY D. SODERQUIST & A.A. SOMMER, JR., UNDERSTANDING CORPORATION LAW 208 (1990) (declaring the major limitation on the payment of dividends to be the requirement that dividends be distributed solely from earned surplus); *id.* at 208-12 (offering a general overview of limitations on dividends).

17. *See* CAL. INS. CODE §§ 1215-1215.16 (West 1993) (setting forth the provisions of the Holding Company Act).

18. *Id.* § 1215.4(d) (amended by Chapter 974); *see id.* § 12900 (West Supp. 1993) (establishing the office of the Insurance Commissioner as an elective post); *see also* *Garris v. Carpenter*, 33 Cal. App. 2d 649, 656 (1939) (describing the Insurance Commissioner as a ministerial officer, who must exercise broad judgment and discretion when performing his duties); 1 CAL. INSURANCE LAW & PRAC., *supra* note 1, at § 1.07[1] (surveying the authority of the Insurance Commissioner). *See generally* Industry Advisory Committee, *Report to the Subcommittee of the National Association of Insurance Commissioners on Holding Company Legislation*, 1 NAIC PROCEEDINGS 176-81 (1969) (tracing the background of holding company legislation).

19. CAL. INS. CODE § 1215.4(d) (amended by Chapter 974).

reasonableness of an insurer's surplus, Chapter 974 mandates the consideration of such factors as the quality of a company's earnings and the inclusion of extra-ordinary accounting items.²⁰

Prior law directed domestic life insurers who were issuing policies on the reserve²¹ plan to make dividends from available profits after retaining unimpaired assets amounting to the aggregate of: (1) The entire capital stock;²² (2) a sum sufficient to pay all losses reported or incurred in the course of settlement, and all liabilities; and (3) a sum sufficient to reinsure all outstanding policies.²³ Chapter 974 declares earned surplus²⁴ to be the only source of dividends, unless exceptions apply.²⁵ For a domestic incorporated life insurer who is issuing policies in the reserve plan, Chapter 974 provides that the earned surplus cannot yield dividends, if it is derived from mere appreciation in the value of assets.²⁶

Existing law entrusts the Insurance Commissioner with the task of regulating the financial affairs of insurers, including insolvency and rehabilitation.²⁷ Chapter 974 obligates life insurers to annually file risk-based capital reports, which address the various risks that affect an insurer's assets.²⁸ Chapter 974 authorizes the Commissioner to resort to specified measures of action if the report warrants such actions.²⁹

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20. *Id.* § 1215.5(b)(11) (amended by Chapter 974).

21. *See* Golter, *supra* note 12, at § 4:29-4:32 (1988) (discussing various types of reserves).

22. *See* WILLIAM W. COOK, *THE PRINCIPLES OF CORPORATION LAW* 35 (1925) (defining capital stock as already-paid or to-be-paid amounts by shareholders to subsidize the operations of the corporation); *see also* *Tapscott v. Mexican Colo. River Land Co.*, 153 Cal. 664, 667-68 (1908) (defining capital stock as the actual property of a corporation); HARRY, GOLTER, *FLETCHER CYCLOPEDIA CORP.* § 5079 (1986) (stating that capital stock was formerly held to mean a sum fixed by a corporate charter to be paid by shareholders so that a corporation could conduct its business). *But see id.* (noting that the former meaning of capital stock is currently reflected by the term stated capital in most modern corporation acts, which avoid using the older term).

23. 1935 Cal. Stat. ch. 145, § 10530, at 655 (enacting CAL. INS. CODE § 10530); *see* 5 Op. Cal. Att'y Gen. 91 (1945) (placing the origins of the California Insurance Code § 10530 in historical perspective). *See generally* S.S. HUÉBNER & KENNETH BLACK, JR., *LIFE INSURANCE* 277-90 (9th ed. 1976) (discussing life insurance reserves); *id.* at 319-32 (discussing surplus and its distribution).

24. *See* CAL. INS. CODE § 10530(d) (amended by Chapter 974) (defining earned surplus).

25. *Id.* § 10530(a) (amended by Chapter 974). *See generally* 44 C.J.S. *Insurance* § 108 (1993) (covering the topics of surplus and dividends).

26. CAL. INS. CODE § 10530(b) (amended by Chapter 974).

27. *Id.* § 1037 (West 1993); *see* *Caminetti v. Pacific Mutual Life Ins. Co.*, 22 Cal. 2d 344, 360-61, 139 P.2d 908, 917 (1943) (upholding the constitutionality of statutes designed to appoint a state insurance commissioner as a rehabilitator); 39 CAL. JUR., *Insurance Companies* § 168 (1977) (explaining the Insurance Commissioner's role in rehabilitation); *see also* JOHN ALAN APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW & PRACTICE* §§ 10901-10906 (1982) (addressing rehabilitation of delinquent insurers through reorganization); 44 C.J.S. *Insurance* § 170 (1993) (discussing rehabilitation and conservation).

28. CAL. INS. CODE § 10552(a) (enacted by Chapter 974). *See generally* ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW* § 1.3(a)-(b) (1988) (discussing risk and risk management).

29. CAL. INS. CODE §§ 10554-10556 (enacted by Chapter 974).

Commercial Transactions; sureties—exoneration

Civil Code §§ 2819, 2822 (amended).

AB 1402 (Morrow); 1993 STAT. Ch. 149

Existing law provides that the acceptance by a creditor¹ of any reduction in the obligation² of a principal debtor³ reduces the obligation of a surety⁴ upon the debt.⁵ Prior law exonerated a surety where the creditor, without the consent of the surety and without indemnification of the surety by the principal debtor, altered the obligation of the principal debtor or the remedies against the debtor.⁶ Chapter 149 provides that an

1. See CAL. CIV. CODE § 3430 (West 1970) (defining creditor as one in whose favor an obligation exists, and thus may become entitled to the payment of money).

2. See *id.* § 1427 (West 1982) (defining obligation as a legal duty, by which a person is bound to do or not to do a certain thing).

3. See *id.* § 3429 (West 1970) (defining debtor as one who, by reason of an existing obligation, is or may become liable to pay money to another, whether such liability is certain or contingent).

4. See *id.* § 2787 (West 1993) (defining surety as one who promises to answer for the debt or default of another, or pledges security therefor); see also *id.* (providing that the distinction between sureties and guarantors is abolished and that both terms have the same meaning); RESTATEMENT OF SECURITY § 82 cmt. b (1941) (defining surety as the person who is bound on an obligation from which another, by the discharge of a duty, should relieve him); RESTATEMENT (THIRD) OF SURETYSHIP § 1 (Tentative Draft No. 1, 1992) (stating that a surety has suretyship status whenever the principal debtor owes performance of a duty to the creditor and, pursuant to a contract, the surety is subject to a secondary obligation, where either the surety also owes performance of the duty of the principal debtor to the creditor or the creditor has recourse against the surety or its property); ARTHUR A. STEARNS, THE LAW OF SURETYSHIP § 1.1 (J. Elder rev., 5th ed. 1951) (defining suretyship as a contractual relationship where one person is answerable for the debt or default of another).

5. CAL. CIV. CODE § 2822(a) (amended by Chapter 149); see *Durgin v. Kaplan*, 68 Cal. 2d 81, 88-89, 436 P.2d 70, 75-76, 65 Cal. Rptr. 158, 163-64 (1968) (holding that where a creditor elects to accept securities from the principal debtor in a bankruptcy court settlement in satisfaction of the debt owed him, he cannot later recover from the guarantor, as the acceptance of the stock fully satisfied the debt and under Civil Code § 2822, fully exonerates the surety); *Union Bank v. Ross*, 54 Cal. App. 3d 290, 294-95, 126 Cal. Rptr. 646, 649 (1976) (holding that permitting the guarantor to waive his right to require the creditor to sell collateral provided by the principal debtor, and which was sufficient to retire the debt upon demand, was valid and not against public policy); *Wise v. Clapper*, 257 Cal. App. 2d 770, 774, 65 Cal. Rptr. 231, 233 (1968) (holding that the acceptance by a creditor of partial payment reduces the obligation of the surety to the extent of the payment, but does not exonerate the surety; whereas, an extension of time for payment, without the consent of the surety, constitutes a material alteration of the original and discharges the surety); cf. MONT. CODE ANN. § 28-11-216 (1992); N.D. CENT. CODE § 22-01-18 (1991); S.D. CODIFIED LAWS ANN. § 56-1-25 (1992) (providing that the acceptance by the creditor of anything in partial satisfaction of an obligation reduces the obligation of the guarantor in the same measure as it does the principal debtor, but does not otherwise affect the obligation of the guarantor).

6. 1939 Cal. Stat. ch. 453, sec. 22, at 1799 (amending CAL. CIV. CODE § 2819); see *Texaco Refining & Marketing, Inc. v. Aetna Casualty & Surety Co.*, 895 F.2d 637, 639-640 (9th Cir. 1990) (holding that material alteration of the agreement between the creditor and debtor was sufficient to exonerate the surety, without any showing of prejudice to the surety; and knowledge by the surety, without consent to the proposed alterations, does not prevent the surety from being exonerated); *In re Gil West, Inc.*, 19 B.R. 949, 951-52 (Bankr. E.D. Cal. 1982) (holding that where a creditor has an obligation involuntarily altered by a bankruptcy proceeding, the surety is not exonerated, because Civil Code § 2819 requires an act by the creditor); *Bennett v. Leatherby*, 3 Cal. App. 4th 449, 453, 4 Cal. Rptr. 2d 340, 343 (1992) (holding that where the creditor releases or impairs the

agreement by a creditor to accept a smaller sum from the principal debtor, without the prior consent of the surety and without any other change to the underlying agreement between the creditor and the principal debtor, does not exonerate the surety for the lesser sum agreed upon.⁷

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surety's remedies against a principal debtor, the surety is exonerated); *V.I.P. Agency of N. Cal., Inc. v. Duffy Electronics, Inc.*, 92 Cal. App. 3d 849, 853, 155 Cal. Rptr. 45, 47 (1979) (holding that when a creditor agrees to a stipulated judgment, which extends time for payment, it materially alters the obligation of the principal debtor and thus exonerates the surety); *cf.* MONT. CODE ANN. § 28-11-211 (1993); N.D. CENT. CODE § 22-01-15 (1991); S.D. CODIFIED LAWS ANN. § 56-1-22 (Michie 1988) (providing that the guarantor is exonerated if, without the consent of the guarantor, the original obligation of the principal debtor is altered in any respect or the remedies or rights of the creditor against the principal are in any way impaired or suspended). *But see* ITT Diversified Credit Corp. v. Highlands Ins. Co., 191 Cal. App. 3d 301, 308, 236 Cal. Rptr. 433, 438 (1987) (holding that the proper approach is whether the stipulated judgment materially modified the original obligation in a manner not contemplated by the surety, as well as examining whether the principal's default preceded the judgment).

7. CAL. CIV. CODE § 2819 (amended by Chapter 149); *id.* § 2822(b) (amended by Chapter 149); *see id.* § 2819 (amended by Chapter 149) (providing that the surety is exonerated if the creditor alters the original obligation between the creditor and principal debtor, except that Civil Code § 2822(b) supersedes and controls over this section in cases where both sections are applicable); *id.* § 2822(a) (amended by Chapter 149) (providing that if the surety is liable upon only a portion of an obligation and the principal debtor provides partial satisfaction of the obligation, the principal debtor may designate the portion of the obligation that is to be satisfied); *see also* *Kennedy v. Moyer*, 5 Cal. App. 2d 29, 30-31, 42 P.2d 352, 352-53 (1935) (holding that the guarantor of the lessee's agreement to pay the lessor a certain amount monthly in a written lease for a year was not released from the obligation by the lessor and lessee subsequently executing an oral agreement reducing the amount of the monthly payments without the guarantor's consent). *But see* *Reese v. United States*, 76 U.S. 13, 21 (1869) (stating that a change in a contract, without the consent of the sureties, releases the sureties from their obligation even though the change may be beneficial or trivial to the sureties); *Ralston-Purina Co. v. Carter*, 210 Cal. App. 2d 372, 378, 26 Cal. Rptr. 690, 694 (1962) (stating that parties to a guaranty obligation cannot alter its terms without the guarantor's consent, even though it may be to the guarantor's advantage); RESTATEMENT OF SECURITY §§ 127-129 (1941) (discussing how modification to the agreement between the principal debtor and the creditor will discharge the surety from liability); RESTATEMENT (THIRD) OF SURETYSHIP §§ 33, 35-37 (Tentative Draft No. 2, 1993) (describing the effect upon the surety of a release, extension, or other modification of the underlying obligation by the creditor); ARTHUR A. STEARNS, THE LAW OF SURETYSHIP §§ 6.1-6.55 (J. Elder rev., 5th ed. 1951) (discussing exoneration of the surety by material alteration of the principal contract by the creditor, by extension of time to the principal debtor by the creditor, and by the release of the surety through actions of the creditor). *See generally* 1993 Cal. Legis. Serv. ch. 149, sec. 3, at 1170 (declaring that the amendment of CAL. CIV. CODE § 2822 does not constitute a change in, but is declaratory of existing law); ASSEMBLY COMMITTEE ON JUDICIARY, COMMITTEE ANALYSIS OF AB 1402, at 3 (May 12, 1993) (stating these amendments were contemplated as the result of potential litigation, where a commercial tenant negotiated a reduction in rent with the landlord without the consent of the tenant's surety, the tenant a short time later becoming bankrupt, and the surety now trying to escape all liability under the lease by claiming the underlying obligation was materially altered and thus the surety is completely exonerated from liability).