Close Corporation Securities Qualification: A Call for an Extension of Prior Intent

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CLOSE CORPORATION SECURITIES QUALIFICATION: A CALL FOR AN EXTENSION OF PRIOR INTENT

INTRODUCTION

On January 1, 1977, the new California General Corporation Law became effective. Scattered throughout this legislation are provisions designed to guarantee judicial recognition of shareholder agreements in close corporations, even if such agreements fail to distinguish between the powers and duties of shareholders and directors, thus violating the traditional corporate norm. Most commentators have viewed this statutory scheme as a laudatory approach to the problems associated with shareholder agreements in the close corporate situation. However, the current state securities qualification laws limit the availability of this guarantee by forcing close corporations to qualify stock issuances.

Specifically, section 260.102.4(b) of Title 10 of the California Administrative Code provides that a corporation does not have one class of stock if there exists, or is intended to be executed, a shareholders’ agreement which affects the rights, preferences, privileges, or restrictions of or on a corporation’s stock in a manner not applicable to all outstanding shares.

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1. CAL. CORP. CODE §§ 100-2300 (West 1977).
2. The legislative committee comment that follows CAL. CORP. CODE § 158 (West 1977) states:
   - Under prior law the operation of a close corporation is unnecessarily hindered by the failure of corporation statutes to recognize the unique attributes of these corporations.
   - The intent of the close corporation provisions in the new law is to statutorily recognize the unique characteristics of such corporate entities and permit tailoring of the traditional corporate norm to the needs of these closely held enterprises.

See text accompanying notes 47-57 infra.


4. Under CAL. CORP. CODE §§ 25110, 25120, 25130 (West 1977), it is unlawful for any corporation to offer or sell any security unless such sale or issuance has been qualified or exempted from qualification. For a discussion of state securities qualification procedures, see notes 66-85 and accompanying text infra.

5. This regulation was adopted pursuant to CAL. CORP. CODE § 25610 (West
Since almost all significant shareholder agreements affect the rights, preferences, privileges, or restrictions usually associated with the ownership of stock, this regulation effectively eliminates the small offering exemption to the requirements of Corporations Code section 25110.\(^6\) In addition, Corporations Code section 25120 requires that securities of an existing corporation be qualified in the event of a conversion to close corporate status if a shareholders' agreement exists which materially and adversely affects any class of shareholders, even though section 24103(e) has been amended to exclude corporate conversions to close corporate status.\(^7\)

This comment will review the present law regarding shareholder agreements and security qualification procedures. These statutes and administrative regulations will then be examined in the context of typical close corporation situations. Additionally, the comment will demonstrate that these qualification requirements subject the majority of close corporate stock issuances to the unnecessary burdens associated with the qualification process, thereby reducing the desirability of incorporating under the close corporation statutes.

**THE CALIFORNIA CLOSE CORPORATION: AN INFRINGEMENT OF THE TRADITIONAL CORPORATE NORM**

In California a close corporation is defined as a corporation whose articles contain both a provision limiting the number of

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\(^6\) Under Cal. Corp. Code § 25102(h) (West 1977), corporations are exempted from the provisions of Cal. Corp. Code § 25110 (West 1977) if: (a) after the completion of the transaction there will be only one class of voting common stock outstanding and there will be no more than ten beneficial owners of such stock; (b) a legend is placed upon each certificate which restricts the transfer of such stock; (c) no advertisements have been used to promote the sale of the offer; (d) no selling expenses have been paid in connection with the offer of the shares; (e) the consideration paid for the stocks meets the requirements of subdivision (3); (f) no promotional consideration has been paid in connection with the founding and organization of the corporation; and (g) a form of notice, signed by an active member of the State Bar, is sent to the Office of the Commissioner no later than ten days after receiving the consideration for the stocks. See Arhelger, *The Close Corporation Exemption*, 48 L.A. B. Bull. 55, 55-61 (1972); Ziskin, *California’s Expanded Close-Corporation Exemption and the Lawyer’s Role Thereunder*, 49 Cal. St. B. J. 248, 249 n.5 (1974). The provisions of Cal. Corp. Code § 25120 (West 1977) can be waived by the Commissioner in any instance where it is determined that qualification is not necessary to protect investors or the public in general. Cal. Corp. Code § 25105 (West 1977).

\(^7\) See 1978 Cal. Legis. Serv. ch. 370, at 1041.
record shareholders to a specific number not to exceed ten, and a statement which says "[t]his corporation is a close corporation." In addition, California Corporations Code section 202 requires that the word "corporation" be contained in the name of the business. An existing corporation may convert itself into a close corporation by including these provisions in its articles. The effectiveness of such an amendment is conditioned upon the approval of all outstanding shares regardless of class or limitations on voting rights.

Traditional corporate theory views shareholders and directors as two separate and distinct groups, each having exclusive rights and duties. Under this concept, authority to direct the general policy of the corporation is extended solely to the board of directors. Shareholders are, therefore, specifically denied such power and are seen merely as the owners of the enterprise. However, as the owners of the corporation, shareholders are granted the power to control the membership of the board and action involving extraordinary corporate matters.

8. CAL. CORP. CODE § 158 (West 1977). The number of actual record holders may exceed ten under the counting rules of that section. It is provided that a husband and wife and the personal representative of either of them are counted as one regardless of how the shares are held between them. A trust or personal representative of a decedent holding shares will also be counted as one regardless of the number of beneficiaries or trustees. Further, a partnership or corporation holding shares is counted as one. Id. § 158(d); CAL. ADMIN. CODE tit. 10, § 260.102.5 (1977); see Arhelger, The Close Corporation Exemption, 48 L.A. B. Bull. 55, 56 (1972); Jordan, supra note 3, at 1097.

9. CAL. CORP. CODE § 158(b) (West 1977).

10. Id.


Even though this concept has been accepted as the legal model, it is clear that day-to-day working practice does not conform to this norm. The reality is that directors often serve merely as "rubber stamps" for decisions that are typically made by top executives. M. MACE, DIRECTORS: MYTH AND REALITY 47, 48, 68, 185 (1971); Eisenberg, Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants, 63 CALIF. L. REV. 375, 376-84 (1975).

12. See, e.g., HENN, supra note 11, at 361-62; Eisenberg, The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking, 57 CALIF. L. REV. 1, 4-6 (1969); Hetherington, Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility, 21 STAN. L. REV. 248, 250-51 (1969) [hereinafter cited as Hetherington].

13. Modern commentators have noted that in publicly-held corporations the distribution of equity securities among vast numbers of people has created shareholder apathy with respect to board elections. Board members are, therefore, quite capable of perpetuating themselves as directors with only occasional difficulty. Hetherington, supra note 12, at 252-54.

Shareholders are also given exclusive rights to control management decisions respecting such actions as the amendment of articles, mergers, consolidations, shares affecting substantially all of the corporation's assets, and voluntary dissolution. How-
In the close corporation setting, however, this division of power is not always observed. Instead, the shareholders of a close corporation are generally both the investors of capital and the managers. In such a situation, it is not surprising to find that the shareholders want not only a direct voice in day-to-day management, but assurance that important decisions will be within their control. In fact, the shareholders often view themselves as partners, frequently failing to distinguish between voting power at the shareholder level and voting power at the directorship level.4

Shareholder agreements are typically used in close corporations as a means of assuring shareholders this degree of control by granting them a direct voice in ordinary decision-making.5 These agreements specifying rights and duties can extend to a broad range of activities. The most important areas covered are those relating to the manner of electing officers and directors, the allocation of decision-making authority to specified individuals, the creation of a veto power over certain corporate actions in one or more of the participants, and the allocation of dividends.6

Vesting control over certain corporate decisions in a specified shareholder, or group of shareholders, can cause problems. Of these problems, deadlock is potentially the most serious because it can lead to paralysis of the corporate decision-making process. Thus, it is important for shareholders to provide methods of resolving issues requiring action in the event of such a crisis. One such method is the use of a binding arbitrator whereby the shareholders can agree that, in the case of a deadlock, the decision of some neutral third party will con-

-ever, since shareholder apathy extends to this area as well, it is most likely that such decisions are also controlled by the board in most instances. Henn, supra note 11, at 361-62, 381; Hetherington, supra note 12, at 251 n.10.

14. See, e.g., Henn, supra note 11, at 507; 1 P. O'Neal, Close Corporations: Law and Practice § 1.07 (2nd ed. 1971) [hereinafter cited as O'Neal]; Berger, supra note 3, at 590, 591 n.30.


Of course, it is possible to vest rights related to corporate decision-making in shareholders by means other than shareholder agreements. Typically these devices involve clauses in the corporation's articles requiring supermajority votes with respect to specified matters, or the issuing of equity securities that have differing voting rights. See, e.g., O'Neal & Janke, supra note 15, at 27-34.
This eliminates the sole disadvantage arising from shareholder agreements, and allows the shareholders to protect their investment through the use of partnership-type practices while gaining the advantages of limited liability and corporate taxation.

**Shareholder Agreements**

*The Judicial Approach*

Since traditional theory distinguishes between the powers of shareholders and directors by making exclusive grants of rights to each group, the use of shareholder agreements which effectively disregard this distinction was frowned on by the courts. In fact, in actions seeking the enforcement of shareholder agreements, the courts usually disregarded the agreement entirely. However, the courts distinguished between agreements that controlled the actions of shareholders as shareholders, and those that controlled their actions as directors. When the agreement involved control of shareholder ac-

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17. Under Cal. Civ. Proc. Code §§ 1281-1288.8 (West 1972), any controversy can be submitted to arbitration, provided that the parties have the foresight to agree in writing to submit to the arbitration process before the problem arises. If the parties have so planned, the dispute may be submitted for resolution to the arbitrator who then makes a decision effectively settling the issue.

Many practitioners are convinced that the arbitration process simply cannot maintain intimate relationships necessary for the effective management of close-corporations. However, the fact is that the use of arbitration clauses is growing due to their satisfactory performance. As a result, the use of binding arbitration should be seriously considered in any case where there exists the potential of deadlock. See, e.g., 2 F. O’Neal, Close Corporations: Law and Practice §§ 9.08-9.25 (2d ed. 1971); Hornstein, Arbitration in Incorporated Partnerships, 108 ARB. J. 229, 231 (1963); Note, Mandatory Arbitration as a Remedy for Intra-Close Corporate Disputes, 56 VA. L. REV. 271, 279-80 (1970).

18. The doctrine of limited shareholder liability has not always been recognized as a corporate attribute. Indeed, California held shareholders subject to unlimited liability on a proportionate basis until 1928. Henn, supra note 11, at 96 n.4, 110 n.2.

19. Corporate income is usually subjected to double taxation; once when the corporation realizes earnings, I.R.C. § 61(a)(2), and again at the shareholder level where corporate dividends are also taxed, I.R.C. § 61(a)(7).

While this may not appear to be much of an advantage, it should be noted that in certain situations corporate taxation may actually increase net in-pocket income since retained earnings of the corporation are not subject to taxation even though they increase the business owners’ net worth. Z. Cavitch, Tax Planning for Corporations and Shareholders § 1.01[1][b] (1978). Furthermore, if this tax schedule is not advantageous, incorporation may still put more actual money into the hands of the business owner if the Subsection S election is available since, for all practical purposes, double taxation is eliminated under that provision. Id. § 3.01. For a complete discussion of the tax aspects of incorporating as a close-corporation, see T. Ness & E. Vogel, Taxation of the Closely Held Corporation (1967).

tion courts generally invalidated the agreement on the theory that shareholders owed a duty to the corporation to exercise their discretion freely. In addition, such an agreement separated voting power from ownership by delegating voting rights to a specific individual or group.\(^{21}\)

In a frequently cited case, *Harvey v. Linville Improvement Co.*,\(^{22}\) the Supreme Court of North Carolina invalidated a shareholders’ agreement that required the participants to pool their stock, transfer it to trustees, and authorize the trustees to vote all such stock at corporate meetings as they saw fit. The court stated that it was against public policy to permit

large blocks of stock to be irrevocably tied up for the purpose of being voted in solido, for the interest of a clique or section of the stockholders, and not according to the judgment of each stockholder, for the benefit of the entire corporation. . . . The power to vote is inherently connected to and inseparable from the real ownership of each share, and can only be delegated by proxy with power of revocation.\(^{23}\)

The more modern cases have rejected this viewpoint.\(^{21}\) Instead, courts now refuse to invalidate these types of agreements per se and focus on the purpose of the agreement. If the court determines that the purpose is not violative of public policy, the agreement will be enforced. This trend has become so widespread that today the validity of a shareholders’ agreement that controls the actions of the shareholders as shareholders can be assumed.\(^{25}\)

Case law involving shareholder agreements which controlled the discretion of directors developed in the same pattern, even though courts were careful to distinguish these agreements from those that controlled shareholder discretion.

\(^{21}\) *Henn, supra* note 11, at 528; *O’Neal, supra* note 14, at § 5.04.

\(^{22}\) 118 N.C. 448, 24 S.E. 489 (1896).

\(^{23}\) *Id.* at 453, 24 S.E. at 490.


\(^{25}\) *Henn, supra* note 11, at 527-28; *O’Neal, supra* note 14, at § 5.04. O’Neal does add, however, that the idea that shareholders have a duty to exercise independent judgment is not dead, as he suggests that a shareholders’ agreement might be invalidated depending on the purpose of the agreement and the relevant statutes in effect within the particular jurisdiction. *O’Neal, supra* note 14, at §§ 5.04, 5.06, 5.07.
The traditional view saw the corporate and partnership forms of business organization as mutually exclusive. Thus, courts refused to allow businessmen to operate under the corporate form while reverting to partnership practices when those practices proved to be more convenient. One of the most famous examples of that view was *Manson v. Curtis*, a New York case in which the directors, as owners of a majority of a corporation's stock, agreed that the general manager was to be allowed to shape the policy of the corporation. The court invalidated the agreement, holding that depriving the directors of their statutory duty to manage the corporation violated public policy.

Application of the traditional view was then rejected in a landmark case, *Clark v. Dodge*, where a New York court was willing to validate a shareholders' agreement because the participants owned all of the corporation's stock, and because the agreement was drafted in such a way that it was unlikely to harm creditors. A general rule emerged from that case allowing shareholder agreements that control director discretion, but only where all of the corporation's shareholders participated in an agreement that posed no threat to outside creditors.

The courts in California have also endeavored to follow the distinction between shareholder agreements that control shareholder action and those that control director action. Those agreements controlling the participants' action as shareholders have been unquestioned in the absence of a statutory prohibition. For example, in *Smith v. San Francisco & Northern Pacific Railroad*, the court validated a shareholders' agreement requiring the participants to vote as a unit in the election of directors. The court rejected the defendants' contention that the agreement violated public policy, criticizing that

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27. 223 N.Y. 313, 119 N.E. 559 (1918).
28. Id. at 316-17, 119 N.E. at 560.
29. Id. at 322-25, 119 N.E. at 562.
30. 269 N.Y. 410, 199 N.E. 641 (1936).
31. Id. at 445, 199 N.E. at 642.
32. See Henn, supra note 11, at 532; O'Neal, supra note 14, at § 5.08; Comment, "Shareholders' Agreements" and the Statutory Norm, 43 Cornell L.Q. 68, 74-77 (1957).
34. 115 Cal. 584, 47 P. 582 (1897).
argument as a vague rubric which would allow courts to decide
questions upon the basis of individual preference rather than
upon hard rules of law. The court stated:

It is not in violation of any rule or principle of law for
stockholders, who own a majority of the stock in a corpora-
tion, to cause its affairs to be managed in such a way as
they may think best calculated to further the ends of the
corporation, and, for this purpose, to appoint one or more
proxies who shall vote in such a way as will carry out their
plan.4

The California decisions have not been so uniform with
respect to shareholders’ agreements that control the actions of
shareholders as directors. The majority of cases have held that
such agreements are valid, at least where substantially all of
the shareholders are involved,37 or where the interests of others
are not affected.38 However, some decisions did not follow the
majority, and a conflict developed among the appellate dis-

The cases illustrate that there was some confusion as to
the state of the law with respect to the validity of shareholders’
agreements. At least two courts had expressly invalidated
shareholder agreements, while others enforced them. Some of
the courts that validated the shareholders’ agreements empha-

35. Id. at 600, 47 P. at 587-88.
36. Id. at 600-01, 47 P. at 588.
P.2d 748, 751 (1948); Hyman v. Karl Stern Co., 47 Cal. App. 605, 606-07, 191 P. 47,
47-48 (1926).
P.2d 748 (1948); Conover v. Smith, 83 Cal. App. 227, 256 P. 835 (1927) and Hyman
Co., 120 Cal. App. 2d 157, 260 P.2d 823 (1953) and Smith v. California Thorn Cordage, Inc.,
129 Cal. App. 93, 18 P.2d 393 (1933).
823, 832 (1953); Smith v. California Thorn Cordage, Inc., 129 Cal. App. 93, 101, 18 P.2d
393, 396 (1933).
41. 120 Cal. App. 2d 157, 260 P.2d 823 (1953).
42. Id. at 172-73, 260 P.2d at 832.
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sized that they would place substance over form, noting that the participants had actually intended to act as partners thereby indicating that they would disregard the corporate entity in an appropriate case. As such, it became clear that if corporate planners were to be assured of the enforceability of management controls and the viability of the corporate status, they would have to have the express protection of statutory language.

California's Response—The General Corporation Law

Most commentators agree that the new corporation law was drafted, in part, to clarify the status of shareholder agreements. One commentator stated that the new law explicitly "provides a statutory basis for the drafting of shareholders' agreements through which shareholders of a qualified close corporation can be assured control of the enterprise similar to that exercised in a partnership."

The General Corporation Law contains several provisions pertaining to the validity of shareholder agreements in the close corporation setting. The most significant provisions are contained in Corporations Code sections 186, 300(b), and 706(a). The first of these, section 186, defines a shareholders' agreement as a written agreement among all the shareholders of a close corporation. Section 300(b) provides that any shareholders' agreement that relates to any phase of the affairs of a qualified close corporation is valid. This is limited by section 300(c), which provides that a shareholders' agreement may not alter or waive statutory provisions concerning restrictions on distributions to shareholders, involuntary dissolution proceedings, corporate records and reports or the rights to inspect them, crimes and penalties, filings required by the

43. For example, in Hyman v. Karl Stern Co., 47 Cal. App. 605, 607, 191 P. 47, 47-48 (1926), the court stated: "The association of the two individuals constituted practically a partnership, the corporate organization being a mere agency to be used in conducting the business." See also Conover v. Smith, 83 Cal. App. 227, 231, 256 P. 835, 836 (1927), where the court noted that: "The corporation, under our system, following such an [shareholders'] agreement would be the mere agency of the associates created for the sake of convenience in carrying out the agreement as between those who made the bargain."

44. See Jordan, supra note 3, at 1114; Bradley, supra note 3, at 871.
45. Bradley, supra note 3, at 871.
46. Jordan, supra note 3, at 1114.
48. Id. §§ 1800-1809.
49. Id. §§ 1500-1508.
50. Id. §§ 1600-1605.
51. Id. §§ 2200-2260.
Secretary of State, the definition of close corporation, and specified voting requirements related to mergers and reorganizations. Section 706(a) expressly validates shareholder agreements that control how shareholders vote their shares. Section 706(a) has been written so that it applies very broadly. Indeed, the only limit on the section’s applicability is the fact that it applies specifically to close corporations.

Both validating sections contain provisions stating: “An agreement made pursuant to this subdivision shall terminate when the corporation ceases to be a close corporation, except that if the agreement so provides it shall continue to the extent it is enforceable apart from this subdivision.” When a close corporation loses its close corporation status, it would seem that a shareholders’ agreement could effectively continue only if the contingency were anticipated and provided for by the participants. Thus, the new statute appears to be more restrictive, as the majority view of previous case law held that agreements were to be validated regardless of the setting in which they were made.

These statutes do not control in the case of a non-close corporation. The validity of a shareholders’ agreement in the non-close corporation situation would depend upon the court’s view of previous case law. However, it can be argued that the implications of sections 300(b) and 706(a) require that validity extend only to the close corporation setting. A statutory construction argument, based on the proposition that the legislature could have made a provision for the validity of shareholders’ agreements in the non-close corporation setting but failed to do so because that result was not desired, leads to a conclusion that previous case law has been superseded by legislation that validated shareholder agreements only for close corporations.

52. Id. § 300(c).
53. Id. § 158.
54. Id. § 1111.
55. Id. § 1201(e).
56. Section 706(a) provides in pertinent part: “An agreement made pursuant to this subdivision between shareholders of a close corporation shall terminate when the corporation ceases to be a close corporation. . . .” (emphasis added). Id. § 706(a).
57. Id. §§ 300(b), 706(a).
58. See notes 33-38 and accompanying text supra.
59. See notes 33-43 and accompanying text supra.
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QUALIFICATION PROCEDURES

Currently all states, except Delaware, have statutes that regulate the issuance of corporate securities. These statutes vary in coverage and approach; some have very stringent provisions, while others have provisions that are more lenient. In California, regulation of securities takes the form of qualification. Under this method, the issuer is required to file certain documents with the Corporations Commissioner (hereinafter Commissioner). These documents detail who is involved with the offer, the value of the assets standing behind the offer, and the specifics of any contractual agreement that might affect the proposed offer.

The purpose of the qualification procedure is to prevent the issuance of securities by unscrupulous or incompetent promoters. It is recognized, however, that certain issuances need not be subjected to extensive review. As a result, California has attempted to harmonize the desire to prevent the perpetration of frauds with the desire to provide for expeditious yet adequate qualification procedures by formulating three qualification methods—coordination, notification, and permit.


61. The various statutory schemes are generally classified as being either by: (1) registration of the securities; (2) registration of those who deal in securities; or (3) statutory provisions that provide that engaging in certain specified practices is grounds for criminal prosecution, suspension of trading, or both. For a summary of the broad range of regulations involved with each type of scheme, see W. CAREY, CASES AND MATERIALS ON CORPORATIONS 1478-80 (4th ed. unabr. 1969); Hoffman, Blue Skying an Issue, 13 HOW. L. J. 108, 108-18 (1967).

62. Qualification of securities in California involves one of three procedures: (1) Qualification by Coordination, CAL. CORP. CODE § 25111 (West 1977); (2) Qualification by Notification, id. § 25112; or (3) Qualification by Permit, id. § 25113. For an explanation of these procedures, see notes 66-85 and accompanying text infra.

63. See notes 66-85 and accompanying text infra.

64. 2 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAW § 433 (R. Clark ed. 1977); E. GIACOMINI, J. HARGROVE & W. SMALL, ORGANIZING CORPORATIONS IN CALIFORNIA 172 (1973) [hereinafter cited as GIACOMINI]; see also People v. Syde, 37 Cal. 2d 765, 768, 235 P.2d 601, 603 (1951); In re Hatch, 10 Cal. 2d 147, 151-52, 73 P.2d 885, 887 (1937); In re Leach, 251 Cal. 536, 543, 12 P.2d 3, 6 (1932).

One author notes that the California statutes actually go beyond merely protecting investors from sales fraud because they also attempt to regulate the organization and structure of businesses. See Hoisington, Condominiums and the Corporate Securities Law, 14 HASTINGS L.J. 241, 243 (1963).

Qualification by Coordination

Qualification by coordination is available when a registration statement has been filed with the Securities and Exchange Commission (SEC) under the Securities Act of 1933. The applicant files the necessary papers with the SEC; then, before five business days have elapsed, he files the same papers with the Department of Corporations. The applicant then files statements of maximum and minimum offering prices, underwriting discounts, and commissions. After the application has been on file for at least ten calendar days, and assuming that no stop order is issued by the Commissioner, the application becomes effective when the federal registration statement is declared operative. The applicant must also comply with certain "post-effective" procedures in order to maintain the qualification's effectiveness. Basically this means that the applicant must promptly notify the Commissioner of the date and time at which the federal registration became effective, and of the content of the final federal price amendment.

Qualification by Notification

This method is available only when the issuer is not eligible for qualification by coordination, and is either an issuer of a security registered under section 12 of the Securities and Exchange Act of 1934, or an investment company registered under the Investment Company Act of 1940. Under the notification procedure, the applicant is required to file a form under provisions of Title 10 of the California Administrative Code. Section 260.111 provides that the applicant must include on the "facing page" information concerning the name and princi...
pal business address of the applicant, title and amount of securities being qualified, proposed maximum offering price or nature of the consideration if other than cash, and whether the application is for an open or limited offering qualification. 74

After the "facing page" is completed, the applicant is directed to include information about the type of business engaged in, the purpose for which the proceeds from the sale are to be applied and the method of distribution, and any previous issuance of securities. 75 The qualification will become automatically effective at twelve noon, ten business days after the completion of filing, provided the Commissioner does not issue a stop order. 76

Qualification by Permit

The third method of qualification is by permit. 77 This method is available to issuers who fail to meet the requirements of the other methods, 78 or to issuers attempting a reorganization under Corporations Code section 25120. 79 Due to the restrictions on the use of the first two procedures, qualification by permit is by far the most frequently used method 80 and would seem to be the only method available to the average close corporation.

Qualification by permit requires that the applicant file the same form required by the notification method. 81 In addition, the applicant must include information related to previously granted exemptions under Corporations Code section 25102(h), the value of oil, gas, or mining leases held by the applicant, real estate syndicates, mutual water companies, and churches, as well as exhibits of the corporation's articles, certificate of incorporation, financial statements made pursuant to section 260.613 of Title 10 of the Administrative Code, and a list of names of the proposed purchasers or an identification of the class of proposed offerees. 82

Under this method, qualification becomes effective only upon the issuance of the permit by the Commissioner. Thus,

74. See text accompanying notes 88-93 infra.
76. CAL. CORP. CODE § 25112(c) (West 1977).
77. Id. § 25113.
78. Id. § 25113(a).
79. Id. § 25121.
80. GIACOMINI, supra note 64, at 192.
81. See text accompanying note 74 supra.
82. CAL. ADMIN. CODE tit. 10, § 260.113 (1975).
the Commissioner must take some affirmative action before the securities can be sold. The Code contains no time limit within which the Commissioner must act. However, there is a provision that states that the applicant is entitled to a hearing pursuant to the provisions of the California Administrative Procedure Act when a permit is actually denied. This hearing is to be held within twenty business days after a written request for a hearing is submitted by the applicant. Thus, it has been argued that an applicant can force the Commissioner to grant or deny the permit within the twenty-day period if the applicant believes that an unreasonably long delay has occurred.

The only reported case involving the Commissioner's duty to act within a specified period is Giannini Controls v. Superior Court. Although Giannini was decided before the passage of the statute, it is illustrative of the zealous approach sometimes taken by the Department of Corporations. Giannini was attempting to effect a merger with Datex Corporation. Under the merger proposal, Giannini was to cancel the stock it held in Datex and exchange shares of its common stock for those Datex shares held by the one remaining shareholder at a ratio of 1.8 to 1. Pursuant to this plan, Giannini filed an application for a permit to issue the necessary securities. However, the minority stockholder refused the offer and became entitled to a cash settlement. Giannini asked the Commissioner to issue a certificate stating that no permit would be necessary since no securities were going to be issued. No action was taken by the Commissioner. Hearings were held six months later, but no final pronouncement was made.

Giannini obtained an alternative writ of mandate requiring the Commissioner either to grant the request, or to show cause as to why a peremptory writ of mandate should not issue compelling him to do so. The Commissioner demurred and a peremptory writ was issued. The Commissioner then denied Giannini's request. On appeal, the Commissioner's decision was overturned, and Giannini's request granted. The petition for a hearing before the California Supreme Court was denied.

83. CAL. CORP. CODE § 25113(c) (West 1977); MARSH & VOLK, supra note 65, at § 6.05[2]. This is in contrast to the coordination and notification methods, which do not require that the Commissioner take any action at all since qualification is automatically effective once all the necessary procedures have been complied with. See text accompanying notes 69, 76 supra.

84. CAL. CORP. CODE § 25143(b) (West 1977).

85. MARSH & VOLK, supra note 65, at §§ 2.02[4], 6.05[2].

and after almost eighteen months of litigation, the two corporations were allowed to conclude their merger.87

The Standards Used in the Qualification Procedure

Open and Limited Qualifications. In order to protect the public from unscrupulous investment schemes, the Department of Corporations has drafted regulations establishing standards to evaluate proposed offers of securities. These standards cover a broad range of situations and can be varied depending on whether the applicant is seeking an open or limited qualification.88 If the applicant expects to offer securities to the public at large, an open qualification will be necessary.89 In such situations, the standards are applied strictly because the potential for harm is quite extensive, and there is rarely any opportunity to bargain over the terms of the offer.90 On the other hand, the standards can be applied with greater flexibility when judging limited offerings91 because these issues can only be offered to specifically named or specifically designated classes of people.92 In addition, these issuances often offer the purchasers the opportunity to negotiate the terms of the offer, and, therefore, the potential for fraud is dramatically reduced.93

The Fair, Just, and Equitable Standard. The Corporations Code requires that a proposed offer of securities be deemed "fair, just, and equitable."94 Unfortunately, there is very little guidance as to what that standard means. Section 25140(d) provides that the Commissioner may not issue a stop order or refuse to issue a permit on the grounds that the price at which

87. Id. at 144-50, 49 Cal. Rptr. at 643.
89. Cal. Admin. Code tit. 10 § 260.001(d) (1975) defines open qualification as "a qualification which authorizes the offer and sale of securities to the public generally, without restriction as to persons or class of persons."
90. Marsh & Volk, supra note 65, at § 8.01[5][b].
91. Id.
92. Under Cal. Admin. Code tit. 10, § 260.001(e) (1975), a limited offering qualification is defined as "a qualification which authorizes the offer and sale of securities only to persons designated therein by name or class."
93. Marsh & Volk, supra note 65, at § 8.01[5][b]. For an example of the situations involved with these kinds of issues, see id.
94. Cal. Corp. Code § 25140(a) (West 1977) provides that the Commissioner may issue a stop order denying effectiveness to, or revoking the effectiveness of, any qualification issued pursuant to section 25111 or 25112 in any case where it is found that the proposed issuance or sale of securities is not fair, just, or equitable. Similarly, Cal. Corp. Code § 25140(b) (West 1977) provides that the Commissioner may refuse to issue a permit under section 25113 unless he finds the proposed issuance to be fair, just and equitable.
the security is offered is "unfair, unjust, or inequitable." The section is applicable only when the security is being publicly offered for cash pursuant to a registration statement under the Securities Act of 1933, and is the subject of a firm commitment underwriting by an underwriter, or syndicate of underwriters registered under the Securities and Exchange Act of 1934. Beyond this, there are extensive guidelines that detail the appropriate criteria for interpretation of the "fair, just, and equitable" standard. However, instead of explaining what the phrase means in general terms, these rules look at certain specific provisions of theoretical issuances and dictate what is acceptable.

Otherwise, there is very little legislative or judicial guidance as to what "fair, just, and equitable" means. According to one commentator, this lack of statutory definition should be understandable as "the problem of the appropriate limitation of the discretion of an administrative agency is virtually insoluble. Too limited discretion in the hands of the right administrator can bring about as much public harm as can the broadest discretion in the hands of the wrong administrator." An understanding of the importance of shareholders' agreements to the close corporation and an appreciation of the needless burden qualification procedures placed on the close corporation assist in the analysis and critique of California's securities qualification laws.

THE COMMISSIONER'S REGULATIONS

Offers or Sales of Securities

Under Corporations Code section 25110, it is necessary to qualify securities before they can be offered or sold. The Legislature has exempted close corporations from this general requirement if, among other things, there will only be one class of stock outstanding after the proposed transaction is completed. This exemption will be denied to the vast majority of

95. It has also been noted that the application of the fair, just, and equitable standard is limited by the fact that the Commissioner has the burden of establishing the fact that the offer is unfair, unjust, or inequitable. Marsh & Volk, supra note 65, at § 8.01(1).
97. Id. at §§ 78-78hh-1.
99. Marsh & Volk, supra note 65, at § 8.01(3). In referring to the problem as being "unsoluble," the authors are probably stating that it is unsolvable.
100. Cal. Corp. Code § 25110 (West 1977). For an explanation of this exemption, see note 6 and accompanying text supra. For a detailed analysis of those transactions
close corporations under new section 260.102.4(b) of Title 10 of the California Administrative Code because it provides:

A corporation does not have 'only one class of stock' outstanding if, at the time its shares are issued, there exists or is presently intended to be executed a shareholders' agreement pursuant to which any of the rights, preferences, privileges, or restrictions upon its shares, as enumerated in subdivision (e) of section 25103 of the Code, are or would be modified as to any such shares, or as to the holders of such shares, in a manner not applicable to all outstanding shares.\textsuperscript{101}

This regulation will clearly have a broad effect on California's close corporations since shareholder agreements must, in order to guarantee shareholder control of management and decision-making, affect the rights and privileges associated with stock ownership. This is clearly so with agreements that control the choice of directors and the distribution of dividends since Corporations Code subsections 25103(e)(2) and (7) specifically mention these rights. As to the other areas affected by shareholder agreements, the relation may not be so clear. However, since it will be left to the Department of Corporations to decide whether or not a shareholders' agreement affects changes in the rights, preferences, privileges, or restrictions of or on an issuer's stock, qualification will be required in the vast majority of cases.

Conversions

The securities qualification laws also anticipate that some non-close corporations will find it advantageous to convert to close-corporate status. Normally such a change in a corporation's status would force the enterprise to qualify its outstanding securities.\textsuperscript{102} However, under Corporations Code section 25103(e), changes in the rights, preferences, privileges, or re-

\textsuperscript{101} See note 5 supra.

\textsuperscript{102} CAL. CORP. CODE § 25120 (West 1977) provides:

It is unlawful for any person to offer or sell in this state any security in an issuer transaction in connection with any change in the rights, preferences, privileges, or restrictions of or on outstanding securities or in any exchange of securities by the issuer with its existing security holders exclusively or in any exchange in connection with any merger or consolidation or purchase of corporate assets in consideration wholly or in part of the issuance of securities, unless the security is qualified . . . .
strictions of or on outstanding shares do not materially or adversely affect any class of shareholders if they arise from the conversion of an existing corporation to a close corporation. 103 Unfortunately, this exemption is unavailable where a shareholders' agreement exists that provides for significant management controls, because Corporations Code subsections 25103(e)(2) and (7) provide that changes in dividend or voting rights can materially and adversely affect shareholders. The only other alternative exemption is probably not applicable to the typical close corporation, as it applies only when less than 25% of the affected securities are owned by persons having California addresses. 104

THE IMPACT OF THE SECURITIES QUALIFICATION LAW

To illustrate the potential impact of the securities qualification laws, a representative selection of hypothetical situations will be examined.

Initial Organizations

Many of the problems created by these qualification laws will occur with the initial organization of the enterprise as a close corporation. Suppose, for example, that four individuals having extensive training in electrical engineering decide to organize a small firm that manufactures electrical components. The parties have noted, however, that only A and B have sufficient funds to provide for the financing of the enterprise. As a result, the four agree that A and B will be allowed to protect their investment by rights that guarantee them a preference in the distribution of corporate earnings. The parties then determine that the enterprise should be incorporated as a close corporation. This will insure the validity of the agreement that grants A and B preference in the event of a distribution of earnings and will also allow the company to take advantage of the close corporation exemption from the qualification requirements of Corporations Code section 25110. Under the new regulations, the existence of this shareholders' agreement will force the corporation to qualify any issuance of stock since the close corporation exemption will be unavailable because the corpora-
tion will be viewed as not having only one class of stock.\textsuperscript{105}

In a similar situation involving the initial organization of a business, the organizers, who number less than ten, may decide to pay into the corporate treasury certain amounts of money to be used for the payment of incorporation expenses. In doing so the investors intend for the payment to create an obligation on the part of the corporation to issue stock to them. These same shareholders, recognizing that one of their group has the management skills necessary to operate the business, agree that one individual is to have a veto power over the shareholders' decisions on the election of the board members. The business is then incorporated under the close corporation statute with the hope that the issuance of common stock pursuant to this plan is not within the purview of the qualification laws.

Under section 260.105.23 of Title 10 of the Administrative Code, exemption from the securities qualification requirements is appropriate in any transaction where the corporation incurs an obligation to issue stock as consideration for money being advanced to it for the purpose of covering incorporation costs.\textsuperscript{106} However, the Commissioner's regulations make such an exemption inappropriate because the shareholders' agreement in this example affects the voting rights associated with the ownership of stock.\textsuperscript{107}

\section*{Operational Enterprises}

The regulations will also create problems for businesses that have been in operation for some period of time. Suppose that ABC Corporation initially organizes as a close corporation and issues common stock that bears a legend permitting the sale or transfer of the stocks only after the corporation has first been offered the opportunity to repurchase it. After some years pass, the shareholders agree to allow certain shareholders to freely transfer their stock in the interest of creating greater financial flexibility, on the condition that no such transfer shall

\textsuperscript{105} See Cal. Admin. Code tit. 10, § 260.102.4(b) (1978); text accompanying note 5 supra.

\textsuperscript{106} The Corporations Commissioner has recently reviewed a situation which would have been exactly the same as this one except for the existence of the shareholders' agreement. In that case it was noted that all of the provisions of Cal. Corp. Code § 25102(h) (West 1977) had been complied with. Thus, exemption from securities qualification was appropriate Cal. Corp. Dep't, Opinion Letter OP 77/9C (Sept. 1977).

\textsuperscript{107} See Cal. Admin. Code tit. 10, § 260.102.4(b) (1978); text accompanying note 5 supra.
cause the corporation to lose its close corporate status. Normally the corporation would not need to qualify the issuance should it seek to issue additional common stock, since section 25102(h) exempts close corporation securities offers from qualification requirements when there is only one class of stock. Unfortunately, the Commissioner's regulation will require the corporation to go through the qualification process even though these kinds of stock transfer restrictions have universally been considered fair.

The regulation will have a similar effect on an existing partnership in the event that its members decide to incorporate. One example of this might involve a business owned by three individuals as a general partnership. Over a period of years, the partners have seen the enterprise grow and have decided that limited liability and corporate taxation are now extremely advantageous. As a result, the partners agree to incorporate as a close corporation and transfer all partnership assets to the corporation in exchange for 3,000 shares of common stock with each partner receiving 1,000 shares. Before the issuance of these securities, the partners agree to continue previous partnership practices and grant one of them the sole authority to determine when and if corporate assets can be leased to third parties. Under Corporations Code section 25102(h), it would appear that the subsequent issue of stocks pursuant to the proposed plan is exempted from the qualification requirements of section 25110 since the agreement does not affect any provision of the close corporation exemption. However, under the amended regulations this exemption would be denied merely because there exists a shareholders' agreement which affects voting rights usually associated with the ownership of stock.

Conversions

Corporations Code section 25103(e) will also force qualification of outstanding securities under Corporations Code section 25120 in the event that a non-close corporation decides to

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108. Furthermore, under the regulations it is provided that the Commissioner will not interfere with private contracts between shareholders that restrict transferability of securities so long as the restriction does not unfairly prejudice the opportunity of the holder to realize a reasonable price for the security. CAL. ADMIN. CODE tit. 10, § 260.140.8 (1972).

109. See HENN, supra note 11, at 553-54.

110. See CAL. ADMIN. CODE tit. 10, § 260.102.4(b) (1978); text accompanying note 5 supra.
convert into a statutory close corporation. Suppose that a corporation was founded several years ago as a non-close corporation. At the time of incorporation there were several shareholders involved. As time progressed competitors entered the field, the corporation's earnings declined, and many of the shareholders sold their shares back to other shareholders.

Today the number of record and beneficial shareholders is fewer than ten, and some of those have determined that it would be most beneficial to keep the enterprise's plant facilities and distribution system intact, and convert to the manufacture of a different item analyzed as having great market potential. The proposed corporation is to be operated in a fashion similar to its predecessor with some of the parties supplying management skills and others supplying financial backing. In order to protect their respective interests, the parties enter into a shareholders' agreement that provides that some of the shareholders are to be given preference in regards to dividends. After a review of the Corporations Code, it is determined that conversion to close corporation status will best suit the parties' needs since such a structure will guarantee enforceability of the shareholders' agreement. However, the agreement affects rights and privileges respecting dividends, and since Corporations Code section 25103(e)(2) specifically denies exemption in such situations, qualification will be necessary.

**CRITIQUE OF THE SECURITIES LAWS**

It is presumed that the securities qualification laws are aimed at furthering the goal of protecting the public from unscrupulous securities offers. Arguably, the new administrative and legislative rules aid in the achievement of this goal because they extend administrative review of securities offers to a setting where the necessity for qualification was questionable. As such, a potentially greater number of fraudulent schemes will be discovered, and the public will be protected from that many more inadvisable investment opportunities.

The problem with this line of reasoning is that it is difficult to see how securities offers in the close corporate setting affect the public since the Corporations Code effectively limits the number of potential investors to a maximum of ten. The logical response to this contention is that the Commissioner

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111. *See note 64 and accompanying text supra.*
112. *See note 8 and accompanying text supra.*
has a duty to protect people and not just that larger group known as the "public." This argument seems to lack substance when carefully analyzed. If offers of stock which qualify for the exemption of Corporations Code section 25102(h) are to be subjected to administrative review only when there exists a shareholders' agreement affecting the rights associated with the ownership of those securities, it must be due to the fact that the agreement alone creates the possibility of the offer being fraudulent. However, since Corporations Code section 186 requires that all shareholders participate in such agreements before they can benefit from the enforcement sanctions of Code sections 300(b) and 706(a), it would clearly be necessary for all purchasers to be advised of the agreement. As such, all purchasers would be afforded the opportunity to effectively evaluate the offer without the benefit of the Corporations Department's input.\textsuperscript{113}

Beyond extending the burdens of qualification to close corporations, the regulations will also diminish the attractiveness of incorporating as a close corporation in order to assure protection for the viability of shareholders' agreements. As a result, the number of close corporations will decrease as organizers, due to their reluctance to limit the available pool of potential investors to a maximum of ten,\textsuperscript{114} will incorporate as a general corporation and revert to the old practice of hoping that management controls will be judicially respected. Similarly, those close corporations presently existing will also find their status detrimental as they will have to be sure that current shareholder agreements do not affect stock ownership rights if they ever decide to seek additional capital through the issuance of more common stock.

\textsuperscript{113} Indeed, interaction between shareholders in a setting where they are few in number is considered to be the normal and expected mode of operation. Jordan, \textit{supra} note 3, at 1094 n.1.

\textsuperscript{114} The primary source of capital for small closely-held businesses comes from the personal savings of the organizers and the earnings of the business. Other sources of capital, such as earnings realized from public offerings of stock, play only a minor role in financing such firms. D. Hunt, C. Williams & G. Donaldson, \textit{Basic Business Finance} 575-76 (3rd ed. 1966). This being the case, it would seem that the ability to gather funds from a large group would be advantageous since most individuals have only a limited amount of savings. In fact, one commonly cited advantage of incorporation is that corporate structure allows for the possibility of aggregating large sums of capital. J. Bonneville, L. Dewey & H. Kelly, \textit{Organizing and Financing Business} 70 (6th ed. 1959).
CONCLUSION

The end result of California's securities laws will be a reinstatement of the situation where shareholders could only hope that the courts would respect and enforce their agreements—a situation which the Legislature viewed as being worthy of reform in 1976.\textsuperscript{118} As such, these laws not only extend the burdens of qualification to the close corporation, but thwart the previously expressed intent of the Legislature as well.

\textit{Marc H. Cochran}

\footnote{115. See note 2 and accompanying text \textit{supra}.}