

Fine Tuning the California Small Offering Exemption

California Corporations Code section 25102(h) provides an exemption from qualification for small issuers of securities. While the exemption is beneficial for many small issuers of securities, there are shortcomings in the exemption's provisions and administration. This article suggests specific improvements to help the exemption meet its objective of aiding the small issuer while protecting the investor.

INTRODUCTION

California's 1968 revision of its securities laws¹ enhanced the ability of small businesses² to issue securities. Prior to 1968 both

¹ See California Corporate Securities Act of 1968, 1968 Cal. Stats. 243, ch. 88, § 2 (current version at *Cal. Corp. Code* §§ 25000-25800 (West 1977 & Cum. Supp. 1980)). Marsh & Volk describe the changes of the new laws as falling into six categories. First, the new law granted exemptions from regulation to classes of securities and transactions where regulation was unnecessary to protect investors. Second, it changed the law's jurisdiction and regulation from being based on a business' domicile to being based on the offer or sale of securities in California. Third, it modified the regulatory procedure. Fourth, the law increased the regulation of securities dealers. Fifth, it increased the regulation of non-issuer transactions. Sixth, the new law created new civil remedies for the defrauded investor. 1 H. MARCH & R. VOLK, *PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS* §§ 1.06(2)-(7) (rev. ed. 1979).

² For purposes of this comment, a small business is defined as "one which is independently owned and operated and which is not dominant in its field of operation." 15 U.S.C. § 632 (1978). The federal government uses this definition in determining businesses which are within the purview of the Small Business Act. *Id.* §§ 631-651. The business' number of employees may also be taken into account. The maximum number of employees may vary by industry to take into account the characteristics of each industry. The dollar volume of the business may also be considered. The administrative regulations state that the definition of small business should be limited to the segment of the industry struggling to become or remain competitive. 13 C.F.R. § 121.3(b)(2)(ii) (1979). The regulations include factors used in formulating the size standards for the definition of small business. Among these factors are:

"(i) Concentration of output; that is the portion of the total output of an industry which is accounted for by a limited number of com-

small and large issuers³ of securities had to comply with the same statutory qualification requirements.⁴ In contrast, section 25102(h)⁵ of the new law exempts small securities offerings from

panies. (ii) Coverage ratio, that is, the ratio of the industry's shipment of its primary products, to the total shipments by all industries of the primary products of the industry in question. (iii) Specialization ratio, that is, the ratio of the industry's shipments of its primary products to its total shipments of primary and secondary products. (iv) The total number of concerns in the industry. (v) The size of industry leaders."

Id. § 121.3-1(b)(3) (1979). California has adopted this definition for the purposes of the State Assistance for Recreational Marinas Act of 1979. *Cal. Fin. Code* § 35200 (West Cum. Supp. 1979).

The Small Business Administration has proposed a change in these size determination methods. Under the proposal, only the firm's number of employees is used to determine whether or not it is a small business. The Small Business Administration has set specific employee size standards for each industry. 45 Fed. Reg. 15,442-15,453 (1980).

³ As used in this comment, a small issuer means a small business issuing securities. A large issuer is an issuer not within the definition of a small business.

⁴ 1917 Cal. Stats. ch. 532. Under the law then in effect, an application for a permit to issue securities had to be filed, reviewed and approved by the Commissioner of Corporations even where a sole proprietorship or small family business wanted to incorporate. CAL. CORP. CODE §§ 25500, 26100 (repealed 1968).

⁵ CAL. CORP. CODE § 25102(h) (West 1977) exempts from the qualification requirements:

any offer or sale of voting common stock by a corporation incorporated in any state if, immediately after the proposed sale and issuance, there will be only one class of stock of such corporation outstanding which is owned beneficially by no more than 10 persons, provided all of the following requirements have been met:

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

(2) The offer and sale of such stock is not accompanied by the publication of any advertisement, and no selling expenses have been given, paid, or incurred in connection therewith.

(3) The consideration to be received by the issuer for the stock to be issued shall consist of (i) only assets (which may include cash) of an existing business enterprise transferred to the issuer upon its initial organization, of which all of the persons who are to receive the stock to be issued pursuant to this exemption were owners during, and such enterprise was operated for, a period of not less than one year immediately preceding the proposed issuance, and the ownership of such enterprise immediately prior to such proposed issuance was in the same proportions as the shares

qualification. Consequently, the small offering exemption is now

of stock are to be issued, or (ii) only cash or cancellation of indebtedness for money borrowed or both upon the initial organization of the issuer, provided all such stock is issued for the same price per share, or (iii) only cash, provided the sale is approved in writing by each of the existing shareholders and the purchaser or purchasers or purchasers are existing shareholders, or (iv), in a case where after the proposed issuance there will be only one owner of the stock of the issuer, any legal consideration.

(4) No promotional consideration has been given, paid, or incurred in connection with such issuance. Promotional consideration means any consideration paid directly or indirectly to a person who, acting alone or in conjunction with one or more other persons, takes the initiative in founding and organizing the business or enterprise of an issuer, for services rendered in connection with such founding or organizing.

(5) A notice in a form prescribed by rule of the commissioner, signed by an active member of the State Bar of California, shall be filed with or mailed for filing to the commissioner not later than 10 business days after receipt of consideration for the securities by the issuer, which notice shall contain an opinion of such member of the State Bar of California that the exemption provided by this subdivision is available for the offer and sale of the securities. Such notice, except when filed on behalf of a California corporation, shall be accompanied by an irrevocable consent, in such form as the commissioner by rule prescribes, appointing the commissioner or his successor in office to be the issuer's attorney to receive service of any lawful process in any noncriminal suit, action, or proceeding against it or its successor which arises under this law or any rule or order hereunder after the consent has been filed, with same force and validity as if served personally on the issuer. An issuer on whose behalf a consent has been filed in connection with a previous qualification or exemption from qualification under this law (or application for a permit under any prior law if the application or notice under this law states that such consent is still effective) need not file another. Service may be made by leaving a copy of the process in the office of the commissioner but it is not effective unless (1) the plaintiff, who may be the commissioner in a suit, action or proceeding instituted by him, forthwith sends notice of the service and a copy of the process by registered or certified mail to the defendant or respondent at its last address on file with the commissioner, and (2) the plaintiff's affidavit of compliance with this section is filed in the case on or before the return day of the process, if any, or within such further time as the court allows.

For the purposes of this subdivision, all securities held by a husband and wife, whether or not jointly, shall be considered to be owned by one person, and all securities held by a corporation which has issued stock pursuant to this exemption shall be consid-

an extremely popular method of issuing securities in California.⁶

The legislature enacted the small offering exemption to alleviate the burdens that a small business encounters when raising capital through securities issuance⁷ and to protect the innocent investor.⁸ Despite the exemption's extensive use, it has failed to meet fully its statutory objectives. First, the Department of Corporations is not effectively administering the exemption's safe-

ered to be held by the shareholders to whom it has issued such stock.

⁶ The number of section 25102(h) filings relative to total qualifications demonstrates its wide use.

	<u>1977</u>	<u>1978</u>	<u>1979</u>
Total Qualifications Issued or Effective	5,521	5,814	6,438
Total § 25102(h) Notices Filed	24,526	28,970	33,946

Source: Dept. of Corporations Reports of Activities for January 1, 1979 to June 30, 1979 and July 1, 1979 to December 31, 1979. The Department does not keep data on the dollar volume of the exemptions or qualifications filed.

⁷ The Corporations Commissioner commented during the legislative consideration of the securities law revision in 1968, "This is an area where under the limitation of the (small offering) exemption the (Corporation) Division presently exercises virtually no regulatory purpose, but on the other hand imposes a tremendous burden of expense on the small businessman." Letter from Robert H. Volk, Commissioner of Corporations, to the members of the California Senate Committee on Insurance and Financial Institutions (March 15, 1968) (on file at U.C. DAVIS L. REV.). In signing the Corporate Securities Act of 1968 into law, the Governor stated that, "[t]he bill removes many unnecessary regulatory burdens on legitimate business by providing [an exemption for listed securities and] an exemption for the small businessman setting up his own business under the corporate form." Press Release, Office of the California Governor (May 9, 1968) (on file at U.C. DAVIS L. REV.).

⁸ Protecting the innocent investor is the primary goal of the California securities regulation scheme. See note 13 and accompanying text *infra*. The version of section 25102 which existed before 1969 provided exemptions for various debt instruments. For example, promissory notes not sold to the public or sold to an underwriter for the purpose of resale were exempted from the permit requirements. Former CAL. CORP. CODE § 25102(c) (repealed 1968). A California court of appeals stated the former section's objective as: "The exemptions of section 25102 were designed to avoid any interference with these individual transactions, while protecting the public against the dangers inherent in the indiscriminate sale of instruments of indebtedness." *People v. Walberg*, 263 Cal. App. 2d 286, 69 Cal. Rptr. 457, 460, (2d Dist. 1968).

guards.⁹ The Department has ceased reviewing the exemption filings, making non-compliant securities issues more likely. Administrative review procedures would revitalize the safeguards. Second, many small businesses are unable to use the exemption. For example, because of the statute's consideration restrictions, a small business wishing to raise money by bringing in a new equity participant¹⁰ cannot utilize the exemption.¹¹ Furthermore, the law may preclude a close corporation from using the exemption because of the statute's one class of stock requirement.¹² The legislature and the Corporations Commissioner need to modify the exemption's requirements to eliminate such burdens on small issuers.

This comment briefly describes the securities regulation scheme in California. It then examines the requirements of section 25102(h)—the small offering exemption. The comment analyzes section 25102(h)'s shortcomings and proposes changes in the statute and its administration. These changes will help ensure that section 25102(h) meets its goals of enhancing the small business' ability to issue securities while protecting innocent investors.

I. THE CALIFORNIA SECURITIES REGULATION SCHEME

The primary purpose of California's securities law is to protect innocent investors.¹³ To achieve this purpose, the legislature empowered the Corporations Commissioner to review offers and sales of securities in California.¹⁴ The Commissioner applies a

⁹ See text accompanying notes 124-130 *infra*.

¹⁰ An equity participant is a holder of an ownership interest in a business entity.

¹¹ See text accompanying notes 118-123 *infra*.

¹² See text accompanying notes 96-102 *infra*.

¹³ For cases reiterating this theme, see *Southern California First Nat'l Bank v. Quincy Cass Assoc.*, 3 Cal. 3d 667, 675, 478 P.2d 37, 43, 91 Cal. Rptr. 605, 611 (1970) (court, in holding a broker's commission excessive, stated that the primary purpose of the Corporate Securities Law is to protect innocent investors). *Weinstock v. L.A. Carpet, Inc.*, 234 Cal. App. 2d 809, 815, 44 Cal. Rptr. 852, 856 (2d Dist. 1965). *Crestlawn Memorial Park Ass'n v. Sobienski*, 210 Cal. App. 2d 43, 51, 26 Cal. Rptr. 421, 427 (2d Dist. 1962). *Hargiss v. Royal Air Property, Inc.*, 206 Cal. App. 2d 406, 412, 23 Cal. Rptr. 678, 682 (4th Dist. 1962).

¹⁴ California Securities Act of 1968, CAL. CORP. CODE §§ 25000-25804 (West 1977 & Cum. Supp. 1980).

fair, just and equitable standard in reviewing such transactions.¹⁵ While several statutory provisions refer to this standard,¹⁶ they do not define it. Nonetheless, the Commissioner has promulgated general guidelines on whether specific aspects of a securities issuance will be considered fair or unfair.¹⁷

The Commissioner applies the guidelines in a flexible manner.¹⁸ Thus, the Commissioner considers all the circumstances surrounding the issuance to ensure that all issuees are protected. For example, the issuer should provide non-participating, non-convertible preferred shares with reasonable protection in order to meet the standard; such protection may include making the preferred dividend cumulative.¹⁹ Clearly, the Commissioner, would not allow the sale if the issuance would be unfair. Exempt offerings,²⁰ by their nature, do not require Commissioner approval. The Commissioner only applies the fair, just and equitable standard to securities which require qualification.²¹

Securities issued in California can qualify by coordination,²² notification,²³ or permit.²⁴ Under the first two methods, an issuer

¹⁵ The fair, just and equitable standard was a major feature of the former Corporate Securities Law of 1917. See 1 H. MARSH & R. VOLK, *supra* note 1, at § 1.03(5). The standard has been incorporated into the current statute via a number of sections. See note 16 *infra*.

¹⁶ See CAL. CORP. CODE §§ 25140 (the Commissioner is to judge the fair, just and equitable nature of the securities and the proposed plan of business in issuing stop orders affecting securities qualification and in granting securities issuance permits), 25141 (the Commissioner can impose certain conditions for qualifications if (s)he finds that without the conditions the offering would be unfair, unjust or inequitable), and 25151 (the Commissioner must find that a requested consent for certain securities transfers is fair, just and equitable before giving consent) (West 1977).

¹⁷ See Cal. Admin. Code, tit. 10, § 260.140.

¹⁸ The administrative regulations emphasize that the guidelines provided "are not intended to preclude the application of more liberal or more stringent standards if the circumstances justify. . . ." *Id.* § 260.140.

¹⁹ The regulations state that such protection may also include prohibiting common stock dividends when preferred dividends are in arrears, requiring the consent of the preferred shareholders for any change adverse to their rights, and providing appropriate dividend restrictions on the common stock. *Id.* § 260.140.3.

²⁰ See CAL. CORP. CODE §§ 25100-25106 (West 1977 & Cum. Supp. 1980).

²¹ See text accompanying notes 22-46 *infra* for a discussion of the qualification procedure.

²² CAL. CORP. CODE § 25111 (West 1977). See text accompanying notes 26-29 *infra*.

²³ CAL. CORP. CODE § 25112 (West 1977). See text accompanying notes 30-35

bound by the federal securities law can use steps taken in conforming with federal rules to meet the California requirements. These methods provide a quick and simple procedure where there is less need for state review because of the extensive federal review.²⁵

If an issuer has filed a registration statement under the federal Securities Act of 1933,²⁶ the security issuance can qualify by coordination.²⁷ The issuer files the same documents with the Corporations Commissioner as are filed with the federal Securities and Exchange Commission (SEC).²⁸ The issue qualifies when the federal registration statement becomes effective unless the state Commissioner takes affirmative steps to prevent qualification.²⁹

If the issuer has issued securities under section 12³⁰ of the Securities Exchange Act of 1934,³¹ the issuance can qualify by noti-

infra.

²⁴ CAL. CORP. CODE § 25113 (West 1977). See text accompanying notes 39-46 *infra.*

²⁵ The major difference between review of an issue under California law and that under the federal securities regulation system is that the federal system is a "disclosure" system, whereas California has a "merit" system. Under the federal system, the primary objective of registration is to have the issuer disclose relevant and material information to the potential investor. L. LOSS SECURITIES REGULATION 184-85 (2d ed. 1961). In contrast, under the California system, the Corporations Commissioner evaluates the issue's underlying merit before the issuance is allowed. 2 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAW § 433 (4th ed. 1979). Despite this different approach, the California legislature determined that an investor is sufficiently protected when the issue has to comply with federal securities regulations. This protection justified the reduced state review of the issue. See 1 H. MARSH & R. VOLK, *supra* note 1, at § 6.01(2)(a).

²⁶ 15 U.S.C. §§ 77a-aa (1976).

²⁷ CAL. CORP. CODE § 25111(a) (West 1977).

²⁸ Cal. Admin. Code, tit 10, § 260.111. The documents must be filed with the Corporations Commissioner within five days of the filing with the Securities and Exchange Commission. Cal. Corp. Code § 25111(b) (West 1977).

²⁹ In addition, the issuer must follow certain procedural steps. The qualification automatically becomes effective when the federal registration statement becomes effective, providing (1) the Commissioner has not entered a stop order or suspension order; (2) the qualification application has been on file with the Commissioner for at least 10 days; and (3) the applicant has filed statements of maximum and minimum offering prices, underwriting discounts and commissions. CAL. CORP. CODE § 25111(c) (West 1977).

³⁰ 15 U.S.C. § 78l(g)(1) (1976),

³¹ 15 U.S.C. §§ 77b-77e, 77j, 77k, 77m, 77o, 77s, 78a -78o, 78o-3, 78p-78hh

fication.³² This procedure is only available if the issuer is not eligible for qualification by coordination.³³ Under the notification procedure, the issuer files an application with the Corporations Commissioner. The application must contain certain information about the issuer's business and about the proposed issuance.³⁴ As with coordination, the Commissioner does not review the application. In contrast to coordination, however, the application automatically becomes effective ten business days after filing.³⁵

Generally, small issues cannot qualify by coordination or notification because the issuer will not fall within the 1933³⁶ or 1934³⁷ Acts. A small issuer will usually fall within an exemption to the 1933 Act, foreclosing qualification by notification. The requirements of the 1934 Act generally preclude small businesses from qualifying by notification. A small business will rarely have 500 shareholders³⁸ and usually cannot afford the cost of listing

(1976).

³² CAL. CORP. CODE § 25112 (West 1977). Investment companies regulated under the federal Investment Company Act of 1940 (15 U.S.C. §§ 80a-1 to 80a-52 (1976)) can also qualify by notification. CAL. CORP. CODE § 25112(a) (West 1977).

³³ CAL. CORP. CODE § 25112(a) (West 1977).

³⁴ The application must contain information describing the business, the use of the proceeds, the plan of the securities' distribution, the list of the directors and officers, principal security holders, and certain exhibits (such as a copy of charter documents). Cal. Admin. Code, tit. 10, § 260.112. Much of this information will already have been collected by the issuer to register the securities in compliance with the 1934 Act.

³⁵ CAL. CORP. CODE § 25112(c) (West 1977). If an amendment is filed, the application becomes effective 10 days after the amendment. The issuance of a stop order by the Corporations Commissioner under § 25143 will render the application ineffective.

³⁶ An issuer falls within the provisions of the 1933 Act unless the securities are specifically exempted pursuant to 15 U.S.C. § 77c (1976) or the transaction is specifically exempted pursuant to 15 U.S.C. § 77d (1976). The exemptions most applicable to the small issuer are the Intrastate Exemption, *Id.* § 77c(a)(11), Regulation A, 17 C.F.R. § 230.252 (1979), and Rule 240, *Id.* § 230.240.

³⁷ There are two ways a business can fall within the registration requirements of the 1934 Act. Businesses with securities listed on a national securities exchange and businesses with assets of more than one million dollars and 500 or more shareholders fall within these requirements. 15 U.S.C. §§ 78l(b)(1) & (g)(1) (1976).

³⁸ It is possible that some businesses falling within the small business definition used here will have 500 or more shareholders and more than one million

on a national exchange.

In California, if a non-exempt issue cannot qualify by coordination or notification, it must qualify by permit.³⁹ Qualification by permit is somewhat analogous to registration under federal securities law.⁴⁰ As with federal securities registration, the issuer qualifying the permit submits information for review. An administrative authority then determines whether or not the issuer is eligible to issue the securities.⁴¹ Under the federal system, the issuer files a registration statement which the SEC reviews. Unless the SEC takes affirmative steps to correct a deficiency in the filing, the statement becomes effective in twenty days.⁴² Similarly, in California, the issuer must file a permit application with the Commissioner of Corporations. The application discloses the proposed plan of business, a budget of sources and uses of funds, and financial statements.⁴³

dollars in assets. This would result from the peculiarities of a particular industry, and would be the exceptional case. This possibility exists both under the current and the proposed small business definition used by the federal government. *See* note 2 *supra*.

³⁹ CAL. CORP. CODE § 25113(a) (West 1977). For a general discussion of the process of qualifying by permit, *see* 1 H. MARSH & R. VOLK, *supra* note 1, at § 6.05; 2 H. BALLANTINE & G. STERLING, *supra* note 25, at § 442. An issue can qualify by permit, whether or not it is eligible to qualify by coordination or notification. CAL. CORP. CODE § 25113(a) (West 1977). However, an issuer probably will not want to qualify by permit if it would qualify by the latter two methods. The latter methods save the issuer from the review and documentation of qualification by permit.

⁴⁰ 15 U.S.C. §§ 77f-h (1976).

⁴¹ For a discussion of the major difference between the federal and California systems, *see* note 25 *supra*.

⁴² 15 U.S.C. § 77h (1976). The Commissioner may issue an order refusing to permit the registration statement to become effective until it has been properly amended. *Id.*

⁴³ Additionally, under the administrative regulations, the issuer must submit to the Corporations Commissioner a description of the business; a plan of the stock's distribution; a description of material transactions or agreements between (i) the issuer and affiliated companies and (ii) promoters, officers, principal employees and other key parties, occurring in the previous three years; outstanding securities and options to purchase securities; the names of principal security holders, remuneration of directors, officers and principal shareholders; additional information on debt securities, options and stock bonuses; various exhibits, including a copy of charter documents and a specimen certificate of the security to be issued; copies of shareholder agreements, voting agreements, irrevocable proxies, and contracts made which affect the securities' rights, preferences, privileges or transferability; copies of any advertisement or prospectus

Under qualification by permit,⁴⁴ the Commissioner directly reviews the application, using the fair, just and equitable standard.⁴⁵ Upon approving the application, the Commissioner issues a permit authorizing the issuance of the securities.⁴⁶ An issuer can avoid the qualification requirements if it falls within a statutory exemption.

California grants exemptions from qualification to issuers or transactions meeting specific criteria. There are two types of exemptions: those related to the nature of the issuer and those related to the nature of the transaction or interest offered. For example, in the former case, the statute exempts government securities,⁴⁷ foreign securities,⁴⁸ and bank securities⁴⁹ from the qualification requirements. In the latter case, such interests as commodity contracts⁵⁰ and certain interests in subdivided land⁵¹ are exempted from qualification. The small offering exemption⁵²

connected with the issuance; a description of consideration to be paid for the securities if the consideration is not cash; a list of proposed purchasers; and a number of other required submissions. The issuer must also submit financial statements to the Commissioner after the issuance every six months for a period of 18 months. Cal. Admin. Code, tit. 10, §§ 260.112 & 260.113.

⁴⁴ CAL. CORP. CODE § 25113(a) (West 1977). An issuer probably will not want to qualify by permit if it could qualify by coordination or notification. The latter two methods save the issuer from the review and documentation of qualification by permit.

⁴⁵ See notes 15-21 and accompanying text *supra*, for a discussion of the fair, just and equitable standard. The difference between qualifying by permit, on the one hand, and qualifying by coordination or notification, on the other, can be analyzed by examining who bears the burden of showing the issue's nature. With permit qualification, the issuer bears the burden of showing the Commissioner that the issue is fair, just and equitable. Only if the issuer successfully shows this will the Commissioner grant the permit. In contrast, qualification by coordination and notification automatically become effective unless the Commissioner makes an affirmative finding that the issue is unfair, unjust or inequitable. The Commissioner cannot refuse to allow these latter qualifications merely because (s)he is unable to find that they *are* fair, just and equitable. See 1 H. MARCH & R. VOLK, *supra* note 1, at § 6.01(2)(a).

⁴⁶ Cal. Corp. Code § 25113(c) (West 1977).

⁴⁷ *Id.* § 25100(a).

⁴⁸ *Id.* § 25100(b).

⁴⁹ *Id.* § 25100(c).

⁵⁰ Cal. Admin. Code, tit. 10, § 260.105.18.

⁵¹ Interests in subdivided land, subdivisions or real estate developments are exempted from qualification (provided a non-public utility corporation providing water is not involved). CAL. CORP. CODE § 25100(f) (West 1977).

⁵² *Id.* § 25102(h), set forth in note 5 *supra*.

also falls within this latter type of exemption, as it specifies requirements relating to the securities' issuance. By satisfying an exemption's requirements, an issuer can avoid the detailed filings and disclosure required under qualification.⁵³ This reduced disclosure will save the issuer time and money.⁵⁴ The widely used small offering exemption is an important vehicle for the small business issuing securities in California.⁵⁵

II. THE SMALL OFFERING EXEMPTION

A business must comply with certain requirements to issue stock under the California small offering exemption. Section 25102(h)⁵⁶ places restrictions on the characteristics of the stock itself, the type of consideration paid for shares, and the methods of sale. The statute also imposes specific notice requirements on the issuer. Several provisions such as the consideration restrictions hamper the small business' ability to issue securities and thus frustrate the exemption's objective.⁵⁷ The exemption should be changed in order to better meet the needs of the small securities issuer.

A. Requirements

Section 25102(h) imposes restrictions on both the stock itself and the shareholders. A business can use the exemption only if, immediately after the proposed sale and issuance, there will be one outstanding class of corporate stock.⁵⁸ Moreover, no more

⁵³ Exemptions other than § 25102(h) do not require any submission to the Department of Corporations. CAL. CORP. CODE §§ 25000 - 25106 (West 1977 & Cum. Supp. 1980).

⁵⁴ For a discussion comparing the amount of time and money an issuer expends through qualification as opposed to under the small offering exemption, see note 81 *infra*.

⁵⁵ See note 6 *supra*.

⁵⁶ The text of this section is set forth in note 5 *supra*.

⁵⁷ For a discussion of the exemption's shortcomings, see text accompanying notes 80-130 *infra*.

⁵⁸ CAL. CORP. CODE § 25102(h) (West 1977), set forth in note 5 *supra*. The Commissioner has interpreted the one class of stock requirement to mean that shareholder agreements which vary rights among shareholders fail to meet this requirements. Cal. Admin. Code, tit. 10, § 260.102.4 This interpretation is especially troublesome for close corporations. See text accompanying notes 96-102 *infra*.

than ten persons may beneficially own shares after issuance.⁵⁹ The stock certificate must bear a legend forbidding the transfer of the security without the Corporations Commissioner's prior written consent,⁶⁰ with some exceptions.⁶¹

Besides restricting the transfer of acquired shares, section 25102(h) restricts the type, but not the amount,⁶² of consideration which a purchaser of section 25102(h) stock can use. The type of consideration must fall within one of four specified categories. First, consideration may consist of assets⁶³ of a business which has been in existence for at least a year.⁶⁴ Second, consideration may consist of cash and/or cancellation of indebtedness for money borrowed upon the initial organization of the issuer, if the stock is issued for the same price per share.⁶⁵ Third, consideration may be cash, if the existing shareholders approve the sale in writing and the purchaser or purchasers are existing shareholders.⁶⁶ Finally, payment for the securities may be any legal consideration, if there will be only one owner of the issuer's

⁵⁹ CAL. CORP. CODE § 25102(h) (West 1977), set forth in note 5 *supra*.

⁶⁰ *Id.* § 25102(h); Cal. Admin. Code, tit. 10, § 260.102.6. The Commissioner will consent to the transfer if (s)he finds the transaction to be fair, just and equitable. CAL. CORP. CODE § 25151 (West 1977). The policy reasons for requiring this consent are to ensure that the investor is not purchasing solely for resale and that subsequent transferees receive fair treatment. 1 H. MARSH & R. VOLK, *supra* note 1, at § 11.04. Unlike under the federal system, there is no time period for which the issuee must hold the stock before transferring it. See 17 C.F.R. § 230.144(d)(1) (1979).

⁶¹ Cal. Admin. Code, tit. 10, § 260.141.11 allows transfers without prior consent under limited circumstances such as transfer to the issuer, transfer pursuant to a court order, and transfer to holders of securities of the same class of the same issuer.

⁶² The exemption contains no dollar ceiling on the value of consideration which issuees can pay for § 25102(h) stock.

⁶³ The assets may include cash. CAL. CORP. CODE § 25102(h)(3)(i) (West 1977), set forth in note 5 *supra*.

⁶⁴ *Id.* The assets must be transferred to the issuer upon its initial organization and the proportion of ownership of the business must be the same before and after the securities issuance. *Id.* Thus, a partnership operating for more than a year could change to a corporate form under this provision. The partners' interests would have to be maintained in the same proportion before and after the change.

⁶⁵ *Id.* § 25102(h)(3)(ii). This category covers the incorporation of a new business. The cancellation of indebtedness provision allows for the possibility that investors may have lent money to the corporation before stock is issued.

⁶⁶ *Id.* § 25102(h)(3)(iii). The corporation may sell shares to existing shareholders to raise additional money.

stock after the proposed issuance.⁶⁷ A party may use any of these four categories of consideration when purchasing section 25102(h) stock.

Section 25102(h) also restricts the method of the securities' offer and sale. No advertisement may accompany the offer or sale of the stock.⁶⁸ Advertisement includes nearly every published or oral communication.⁶⁹ There can be no selling expense in connection with the offer or sale.⁷⁰ Selling expense includes commissions, discounts, or other compensation paid to any person as remuneration for selling the securities.⁷¹ No party can give, pay or incur any promotional consideration in connection with the issuance.⁷² Promotional consideration means consideration paid to a person taking the initiative, alone or with others, for services rendered in founding or organizing the issuer's business.⁷³

Finally, after completion of the sale of stock, section 25102(h) requires an issuer to file a timely notice of exemption with the Corporations Commissioner. To be timely filed, the issuer must file the prescribed notice⁷⁴ shortly after receiving payment for the securities.⁷⁵ The notice requires little more than basic information about the issuer and issuees.⁷⁶ The notice also requires

⁶⁷ *Id.* § 25102(h)(3)(iv). This category covers the situation where a sole proprietorship wants to incorporate for potential tax benefits.

⁶⁸ *Id.* § 25102(h)(2).

⁶⁹ Advertising is defined as any written or printed communication or any communication by means of recorded telephone messages or spoken on radio, television, or similar communication media, *Id.* § 25002.

⁷⁰ *Id.* § 25102(h)(2).

⁷¹ Cal. Admin. Code, tit. 10, § 260.102.7.

⁷² CAL. CORP. CODE § 25102(h)(4) (West 1977).

⁷³ *Id.*

⁷⁴ See Cal. Admin. Code, tit. 10, § 260.102.8.

⁷⁵ CAL. CORP. CODE § 25102(h)(5) (West 1977). The issuer must file the notice no later than 10 days after the issuer receives the consideration. *Id.*

⁷⁶ The issuer must disclose the name, address, and state of incorporation of the issuer and the names of the issuees. Additionally, the form requires a confirmation that there will be only one class of stock outstanding owned beneficially by no more than 10 persons; a confirmation that there is no advertising or selling expense or promotional consideration accompanying the sale; a confirmation that, to the best of the issuer's knowledge, the shareholders have not entered into an invalidating shareholders agreement, voting agreement or irrevocable proxy; a confirmation that the transfer restriction will appear on the stock certificates; and the signature of an officer. Cal. Admin. Code, tit. 10, § 260.102.8.

an opinion of counsel and answer as to whether the issuer is a close corporation.⁷⁷ The opinion must certify the exemption's availability based on the attorney's conclusion that the issue meets the statute's requirements.⁷⁸ The Corporations Department files the notice without review.⁷⁹

The requirements of section 25102(h) cover the entire time period from the issuance of the shares, to their acquisition, and through their retention and subsequent disposition. Each requirement is a key part of the comprehensive regulatory scheme under section 25102(h). The legislature designed section 25102(h) to enhance a small business' ability to issue securities while ensuring investor protection. Unfortunately, several components of this scheme hinder, rather than enhance, the statute's purposes.

B. Shortcomings in the Small Offering Exemption

Despite the exemption's wide use⁸⁰ and its advantages over qualification by permit,⁸¹ it has several significant shortcomings.

⁷⁷ Certain of § 25102(h)'s shortcomings are apparent when close corporations seek to use the exemption. See text accompanying notes 88-102 *infra*.

⁷⁸ The opinion the attorney signs states,

"I certify that I am an active member of the State Bar of California. On the basis of the facts stated in the foregoing Notice and other information, including the representations as to the type of consideration received or to be received, supplied to me by officials and shareholders of the issuer and by proposed issuees, it is my opinion that the exemption from qualification with the Commissioner of Corporations provided by Subdivision (h) of Section 25102 of the California Corporations Code is available for the offer and sale of the shares referred to in this Notice."

Cal. Admin. Code, tit. 10, § 260.102.8(a).

⁷⁹ Until recent funding cutbacks, a clerk reviewed the form for obvious errors, but even this practice has now been abandoned. See notes 124-125 and accompanying text *infra*.

⁸⁰ See note 6 *supra*.

⁸¹ Exempting the issuance through the small offering exemption is preferable to qualifying the issue by permit. It should be less time-consuming to collect the information needed to file a notice of issuance of § 25102(h) securities than to collect the information needed to file an application for a permit. (See note 43 and accompanying text, *supra*, for the information required in a permit application. This contrasts with the information required for a § 25102(h) filing. See notes 74-77 and accompanying text *supra*.) Accordingly, expenses such as attorneys' and accountants' fees should be less under the exemption. Filing fees are also much lower. The fee for a § 25102(h) filing is \$25.00. CAL. CORP. CODE § 25608(c) (West 1977). The fee for filing an application for quali-

The shortcomings exist in the restrictions on shareholders and stock, the restrictions on consideration, and in the lack of a Corporations Department review of the notice of exemption. These restrictions should be changed and the government's review increased to cure these problems. These changes will enable section 25102(h) to better meet its objective of helping small businesses issue securities while protecting innocent investors.

1. Restrictions on the Shareholders and the Stock

The ten shareholder limitation⁸² unnecessarily restricts a corporation's ability to raise capital. Raising the number of allowable shareholders⁸³ would enlarge the pool of potential investors. In turn, this would further the small offering exemption's goal of helping the small business raise funds through securities issuance.⁸⁴ Thus corporate issuers, who currently must qualify securities,⁸⁵ could use the exemption.⁸⁶ The exemption contains other

fication by permit is \$100.00 plus 1/10 of 1% of the aggregate value of the securities sought to be sold in California, up to a maximum of \$1,750.00. *Id.* § 25608(e).

A significant period may elapse while the Commissioner reviews an application for a permit. The Commissioner has no time limit within which (s)he must review a permit application. However, if the Commissioner denies a permit application, the applicant is entitled to a hearing within 20 days of filing a written request (unless the Commissioner issues the permit within twenty days or the applicant consents to a later date). CAL. CORP. CODE § 25143(b) (West 1977). Thus, an applicant may force the Commissioner to act on a permit within the twenty days if the applicant believes that an unreasonably long delay has accompanied the processing of the application. 1 H. MARSH & R. VOLK, *supra* note 1, at § 6.05(2). In contrast, § 25102(h) only requires the filing of an exemption notice with the Commissioner, and there is no review procedure. CAL. CORP. CODE § 25102(h)(5) (West 1977).

⁸² CAL. CORP. CODE § 25102(h) (West 1977), set forth in note 5 *supra*.

⁸³ The number of shareholders allowed under section 25102(h) was raised once before. In 1973, the legislature raised the number from five to ten. 1973 Cal. Stats. ch. 390 (effective January 1, 1974). For the effect of this increase on the number of qualification applications filed, see note 137 *infra*.

⁸⁴ Another advantage of this change would be to free some personnel currently reviewing permit applications. They could be utilized to give some review for § 25102(h) filings. See text accompanying note 137 *infra*.

⁸⁵ See text accompanying notes 22-46 *supra*, for a discussion of the qualification requirements.

⁸⁶ For example, in a situation raised in request for a Corporations Commissioner's Opinion, the issuer desired to issue shares to one individual and a limited partnership consisting of three general partners and ten limited partners. The issuer argued that only the individual and the general partners should be

protective measures that are sufficient to safeguard the issuee's investment.⁸⁷

counted and, thus, the issue would conform to the limitation of 10 or fewer shareholders. The Commissioner stated that all the partners should be counted, meaning the proposed issue had 14 issuees. Thus, the exemption was deemed to be unavailable. Cal. Corp. Comm'r Op. No. 79/2C (1979). Except for the shareholder limitation, the exemption would apparently have been available to the issuer in this case.

The Commissioner's Opinions are issued pursuant to CAL. CORP. CODE § 25618 (West 1977) in response to requests by interested persons. They are applicable only to the particular transaction identified in the request and may not be relied upon in connection with other transactions. They would undoubtedly have some persuasive authority in court, as the Commissioner is intimately familiar with the law in this area and is charged with the enforcement of California's securities laws. Only one reported case cites an Opinion, but it is cited only in passing and its authority is not commented on. *See Tomei v. Fairlane Feeding Corp.*, 67 Cal. App. 3d 394, 398, 137 Cal. Rptr. 656, 658 (2d Dist. 1977). The reason that no other reported cases cite the opinions is that the opinions are designed to clarify the legal status of situations involving securities. Thus, in cases where the Commissioner has rendered opinions, there will be less litigation over legal ambiguities. (Note: Prior to January 1, 1972, Commissioner's Opinions were called Interpretive Opinions and Policy Letters.)

⁸⁷ California is the only state which places restrictions on the type of consideration that can be paid for similar limited offering securities. Other states restrict promotional consideration, as does California. Even with the changes proposed in this comment, the exemption's safeguards ensure a fair treatment of all shareholders. *See text accompanying 131-134 infra*, for a discussion of the safeguards afforded to the investor under § 25102(h). For the limited offering exemption of the other states and the District of Columbia, *see* ALA. CODE tit. 8, 8-6-11(a)(9) (1975); ALASKA STAT. § 45-.5.104(b)(5) (1975); ARIZ. REV. STAT. ANN. § 44-1844 (1967); ARK. STAT. ANN. § 67-1248(b)(9)(Cum. Supp. 1979); COLO. REV. STAT. § 11-51-114 (Cum. Supp. 1978); CONN. GEN. STAT. ANN. § 36-490(b)(9) (West Cum. Supp. 1980); DEL. CODE ANN. tit. 6, § 7309(a)(9) (1975); D.C. CODE ANN. § 2-2401(f)(5) (Cum. Supp. 1980); FLA. STAT. ANN. § 517.061(12) (West 1979); GA. CODE ANN. § 97-109(m) (Cum. Supp. 1979); HAW. REV. STAT. § 485-6(9) (Cum. Supp. 1979); IDAHO CODE § 30-1435(8) (Cum. Supp. 1979); ILL. ANN. STAT. ch. 121½, § 137.4(G) (Smith - Hurd Cum. Supp. 1979); IND. CODE ANN. § 23-2-1-2(b)(10) (West 1979); IOWA CODE ANN. § 502.203.9 (West Cum. Supp. 1979-80); KAN. STAT. § 17-1262(n) (Cum. Supp. 1979); KY. REV. STAT. § 292.410(i) (Cum. Supp. 1978); LA. REV. STAT. ANN. § 51:705(12) (West Cum. Supp. 1980); ME. REV. STAT. tit. 32, §§ 874.9 & 874.9A (1978); MD. CORP. & ASS'NS CODE ANN. § 11-602(9) (1975); MASS. GEN. LAWS ANN. ch. 110A, § 402(b)(9) (West Cum. Supp. 1979); MICH. COMP. LAWS ANN. § 451.802(b)(9) (West Cum. Supp. 1979-80); MINN. STAT. ANN. § 80A.15 Subd. 2(h) (West Cum. Supp. 1980); MISS. CODE ANN. § 75-71-53.9 (Cum. Supp. 1979); MO. ANN. STAT. § 409.402(b)(9) (Vernon 1979) (Cum. Supp. 1978); NEV. REV. STAT. § 90.075 (1980); N.J. STAT. ANN. § 49:3-50(b)(9)

Another problem of the restriction on the number of shareholders lies in the method of counting shareholders. The requirements for both close corporation status under Corporations Code section 158(a)⁸⁸ and the small offering exemption specify that there be ten or fewer shareholders.⁸⁹ The methods of counting these shareholders, however, differ. For example, securities held by a partnership are considered owned beneficially by each partner for the purpose of the small offering exemption.⁹⁰ In contrast, under section 158(d),⁹¹ a partnership is counted as one owner, except if formed for the primary purpose of acquiring shares.⁹² In this case, each partner counts as one shareholder.⁹³ This latter provision of section 158(d) adequately protects against forming a partnership to circumvent the restriction on the number of beneficial owners.⁹⁴

A close corporation wanting to issue exempt stock must use two different standards to comply with what is essentially the same restriction. This situation unnecessarily confuses the law and makes compliance more complex and time-consuming. This

(West 1970); N.M. STAT. ANN. § 58-13-30J (1978); N.Y. GEN. BUS. LAW § 352-g (McKinney 1968); N.C. GEN. STAT. § 78-17(9) (1975); N.D. CENT. CODE § 10-04-06(9) (Cum. Supp. 1979); OHIO REV. CODE ANN. § 1707.03(0) (Page 1974); OKLA. STAT. ANN. tit. 71, § 401(b)(9) (West Cum. Supp. 1979-80); OR. REV. STAT. § 59.035(12) (1977); PA. STAT. ANN. tit. 70, § 1-203(d) (Purdon Cum. Supp. 1979-80); S.C. CODE § 35-1-320(9) (1977); S.D. COMPILED LAWS ANN. § 47-31-86.1 (Cum. Supp. 1979); TENN. CODE ANN. § 48-1632(H) (1979); TEX. REV. CIV. STAT. ANN. art. 581-5(I) (Vernon Cum. Supp. 1980); VT. STAT. ANN. tit. 9, § 4204(10) (Cum. Supp. 1979); VA. CODE § 13.1-514(b) (8) (1978); WASH. REV. CODE ANN. § 21.20.320(9) (1978); W. VA. CODE § 32-4-402(b)(9) (1975); WIS. STAT. ANN. § 551.23(10) (West 1978); WYO. STAT. § 17-4-114(b)(ix) (1977).

⁸⁸ CAL. CORP. CODE § 158(a) (West 1977).

⁸⁹ *Id.* § 25102(h), set forth in note 5 *supra*.

⁹⁰ Cal. Admin. Code, tit. 10, § 260.102.5.

⁹¹ CAL. CORP. CODE § 158(d) (West 1977).

⁹² *Id.*

⁹³ *Id.* The same differences in counting methods exist for shares held by a trustee or joint venture. *Id.* and Cal. Admin. Code tit. 10, § 260.102.5. For example, in Cal. Corp. Comm'r Policy Letter No. 19 (1969), the sole proposed shareholder was to be a business trust with more than five beneficiaries. The Commissioner ruled that under § 25102(h), the issuance could not be exempted. *Id.* Under the § 158(d) counting methods, the exemption would have been available because a business trust is regarded as a single shareholder.

⁹⁴ This provision is similar to the counting provision used in federal Rule 240 (17 C.F.R. § 230.240(f) (1979), which exempts from federal registration certain limited offers and sales by closely held issuers.

hinders the small issuer of securities, thus conflicting with one of the objectives of the exemption. Using the counting method of § 158, instead of section 25102(h)'s, would simplify compliance.⁹⁵ At the same time, it would prevent the circumvention of the restriction on the number of shareholders.

The one class of stock requirement also impinges upon a close corporation's use of section 25102(h). This impaired ability results from a Corporations Commissioner ruling that the requirement prohibits close corporations from entering shareholder or voting agreements which vary rights among shareholders.⁹⁶ Many close corporations have such agreements to structure corporate control.⁹⁷ For example, shareholders may agree to allocate corporate authority to specific people or to create veto power over certain actions in one or more participants.⁹⁸ To the extent

⁹⁵ This change is preferable to conforming the § 158 counting method to § 25102(h)'s. It aids the issuer by not limiting the investor pool beyond that already established in the shareholder restriction: existing entities are each treated as one shareholder. At the same time, it retains the protective provision forbidding the formation of partnerships or trusts to circumvent the restrictions.

⁹⁶ Cal. Admin. Code, tit. 10, § 260.102.4. Specifically, the Commissioner has ruled that if there exists or is intended to bring into existence a shareholder agreement pursuant to which rights, preferences, privileges, or restrictions apply in a manner not applicable to all shares, the one class of stock requirement will not be satisfied. *Id.* Voting trusts do not create a second class of stock, because the corporation is not the issuer of the voting trust certificates. Cal. Corp. Comm'r Op. No. 73/43C (1973).

The Department does not collect data on the proportion of total § 25102(h) notices which are filed by close corporations. However, this author conducted a review of § 25102(h) notices filed with the San Francisco office of the Department of Corporations during the period February 6 to 14, 1980. Of the 162 notices filed, 25.3% of the issuers stated they were close corporations, 72.8% stated they were not, and 1.9% did not respond to that portion of the form. This indicates there may be a large number of issuers affected by this restriction.

⁹⁷ See, generally, 1 H. BALLANTINE & G. STERLING, *supra* note 25, at § 62.03; ORGANIZING AND COUNSELING CLOSELY HELD CORPORATIONS 59 (Cal. Cont. Educ. Bar 1977). Shareholder agreements are not a requirement of the close corporation form of ownership. However, they may be desirable features. "Moreover, it should be recognized that shareholder agreements . . . are often, as a practical consideration, quite necessary for the protection of those financially interested in the corporation." *Galler v. Galler*, 32 Ill. 2d 16, 21, 203 N.W.2d 577, 583 (1965).

⁹⁸ See 1 H. BALLANTINE & G. STERLING, *supra* note 25, at §§ 60.02(2)(b) & 62.03 for a general discussion of where shareholder agreements are appropriate.

that such agreements vary rights among shareholders, this ruling prevents small businesses from issuing stock under section 25102(h).

The Commissioner's ruling conflicts with the legislative policy underlying sections 158⁹⁹ and 25102(h).¹⁰⁰ The policy encourages growth and development of limited ownership corporations, while giving all shareholders a voice in decision-making. The Commissioner's ruling, on the other hand, discourages growth by precluding certain close corporations from issuing shares under section 25102(h). The Commissioner's ruling is also unnecessary to give shareholders a voice in decision-making. In a close corporation, all shareholders must consent to a shareholder agreement.¹⁰¹ Since any shareholder can veto an agreement, the desired protection already exists. Thus, allowing close corporations with shareholder agreements to use § 25102(h) meets the statutory objectives.¹⁰²

2. Restrictions on Consideration

The restrictions on consideration¹⁰³ are based on a policy of ensuring that the interests of existing shareholders will not be diluted when the corporation issues new securities.¹⁰⁴ Accordingly, the exemption allows any legal consideration to be paid for the securities where there is only one beneficial owner.¹⁰⁵ In this case, there can be no dilution of the shareholder's interest. The other allowable types of consideration also support this policy. An existing business transferring assets upon its initial organization ensures no dilution by requiring ownership in the same proportion before and after issuance.¹⁰⁶ Furthermore, there can be no dilution of interest in the alternative of cash or cancella-

⁹⁹ See 1 H. BALLANTINE & G. STERLING, *supra* note 25, at § 60.01.

¹⁰⁰ See note 7 *supra*.

¹⁰¹ CAL. CORP. CODE § 186 (West 1977).

¹⁰² For a discussion of the incompatibility of the small offering exemption and the close corporation provisions under this Commissioner's ruling, see Note, *Close Corporation Securities Qualification: A Call for an Extension of Prior Intent*, 19 SANTA CLARA L. REV. 147 (1979).

¹⁰³ See text accompanying notes 62-67 *supra*.

¹⁰⁴ See 1A H. MARSH & R. VOLK, *supra* note 1, at A-1-233; Bickford, *California Corporate Securities Law of 1968: Some Interpretations, Some Problem Areas*, 2 PAC. L. J. 497, 511-12 (1971). Also, see discussion in Cal. Corp. Comm'r Op. Nos. 69/104, 69/106 and 72/143C.

¹⁰⁵ CAL. CORP. CODE § 25102(h)(3)(iv) (West 1977).

¹⁰⁶ *Id.* § 25102(h)(3)(i).

tion of indebtedness upon initial organization because the shareholders have no previous interest in the corporation.¹⁰⁷ When existing shareholders pay cash, the statute requires that all shareholders give their written approval.¹⁰⁸ This approval assures that there will be no undesired dilution.

The consideration restrictions have the effect of foreclosing the use of the exemption in a number of common small business situations. In Commissioner Policy Letter No. 27,¹⁰⁹ a corporation desired to issue securities. All existing shareholders were willing to sign their consent to the proposed offer and sale. However, the issue did not occur at the initial organization of the corporation,¹¹⁰ it was not issued to existing shareholders,¹¹¹ and there was more than one shareholder after the sale of the stock.¹¹² Consequently, the Commissioner held that exemption unavailable because the arrangement failed to come within any of the four allowable categories of consideration.

Despite failing to meet the consideration requirements, the restriction's underlying rationale did not exist in this case. The shareholders were not only aware of, but were willing to accept, possible dilution of their interests resulting from the proposed issuance. Where shareholders consent, they are protected because they are informed of the sale and agree to it. Moreover, allowing such a sale promotes the exemption's goal of aiding the small issuer of securities. Therefore, the exemption should include such a full consent provision.

A small business is often cash-poor¹¹³ and may want to use stock issued through the exemption to pay for organizational and other costs. For example, a newly created small business may want to pay attorney fees with shares of the corporation.¹¹⁴

¹⁰⁷ *Id.* § 25102(h)(3)(ii).

¹⁰⁸ *Id.* § 25102(h)(3)(iii).

¹⁰⁹ Cal. Corp. Comm'r Policy Letter No. 27 (1969).

¹¹⁰ CAL. CORP. CODE §§ 25102(h)(3)(i) & (ii) (West 1977).

¹¹¹ *Id.* § 25102(h)(3)(iii).

¹¹² *Id.* § 25102(h)(3)(iv).

¹¹³ *See generally*, Small Business Financing - The Current Environment and Suggestions for Improvement, special report published by the Nation Association of Securities Dealers, Inc. reprinted in *Hearings Before the Senate Select Committee on Small Business, on Capital Formation* 96th Cong, 1st Sess. 962 (1979).

¹¹⁴ There may be ethical problems for the attorney in accepting stock in a client corporation as remuneration for services. This is beyond the scope of this comment. *See* ABA Comm. on Professional Ethics, Opinion No. 279

However, the exemption's requirements foreclose this type of payment. The only non-cash consideration allowed under section 25102(h) is the cancellation of indebtedness upon initial organization, the assets of a currently existing business, or any legal consideration when there is only one shareholder.¹¹⁵ In Commissioner Policy Letter No. 111¹¹⁶ a corporation proposed to issue shares to an attorney in exchange for future legal services as well as for those required in the corporation's formation. Since this situation fell into none of these categories, the Commissioner ruled that such an issuance would violate the consideration restrictions. The issuer in such a case must then go through the qualification procedure, which might be prohibitively expensive.¹¹⁷ This frustrates the exemption's goal of aiding small business. The exemption should allow any consideration to be accepted upon full written consent of all shareholders. This change would allow the exemption's use in this case. Moreover, the consent exception would harmonize the exemption's use in practice with its goals.

Bringing a new equity participant into an existing corporation after its initial organization will likewise violate the consideration requirements.¹¹⁸ This is a typical way for a small business to

(1949).

¹¹⁵ CAL. CORP. CODE § 25102(h)(3) (West 1977). See text accompanying notes 62-67 *supra*.

¹¹⁶ Cal. Corp. Comm'r Policy Letter No. 111 (1970).

¹¹⁷ Qualification is a less preferable means of issuing securities than exemption. See note 81 *supra*. In Cal. Corp. Comm'r Op. No. 72/98C (1972), a corporation likewise desired to issue shares to an attorney in exchange for services rendered. The corporation proposed to effect this through a "step" transaction. The corporation would first issue section 25102(h) shares to the two principals of the corporation who would then transfer shares to the attorney. The Commissioner ruled that the issue to the principals could be issued under the § 25102(h) exemption, but the transfer to the attorney would have to be effected through a qualification since the consideration was in the form of legal services. *Id.*

¹¹⁸ There is another instance where the current consideration restrictions frustrate small business capital formation. A company may want to issue shares to an existing shareholder in exchange for a cancellation of indebtedness. This type of capital restructuring may be necessary for a business to increase equity participation relative to debt in order to get bank financing. ("As a general rule, most institutional lenders require that at least 50% of the starting capital be contributed by the entrepreneur and/or other investors from their own funds. This constitutes equity in the business, or ownership dollars." Bank of America N.T. & S.A., Steps to Starting a Business (Small Business

raise necessary capital.¹¹⁹ However, in this situation, the corporation is not at its initial organizational stage,¹²⁰ the sale is not to an existing shareholder,¹²¹ and there is more than one shareholder after the sale.¹²² Accordingly, in such cases the Commissioner has stated that the exemption could not be utilized because the issuer failed to meet the statutory consideration requirements.¹²³ The full consent exception would allow this transaction to occur under the small offering exemption.

The objective of the consideration restrictions is to safeguard investors against dilutions adverse to their interests. The restrictions serve this goal in many situations. However, there are situations, such as those just discussed, where the restrictions foreclose the exemption's use by the small issuer. If all stockholders consent, the underlying rationale of the restrictions no longer exists. Therefore, the exemption needs a provision whereby consenting shareholders can use consideration falling outside the currently specified categories.

3. Review of the Notice of Exemption Filing

The Corporations Department needs a review procedure for section 25102(h) filings. Currently, the Department merely places the form submitted by the issuer in a file.¹²⁴ Previously, a

Reporter Series, 1972.)

In a policy letter (Cal. Corp. Comm'r Policy Letter No. 177 (1971)), the Commissioner ruled that since the issuance would occur after the initial organization of the corporation, the proposed issuance could not meet the requirements of CAL. CORP. CODE § 25102(h)(3)(ii) (West 1977). This provision allows cancellation of indebtedness as consideration only upon the initial organization of the issuer, provided that all the stock is issued for the same price per share. *Id.* This is yet another example of the exemption failing to meet the needs of small businesses in the financing of their operations. The Commissioner has ruled that the exemption was unavailable in other cancellation of indebtedness arrangements. See Cal. Corp. Comm'r Op. Nos. 70/18 (1970) & 74/51C (1974).

¹¹⁹ See, for example, Cal. Corp. Comm'r. Op. Nos. 71/2C (1971), 73/32C (1973) & 74/26C (1974); Cal. Corp. Comm'r. Policy Letter Nos. 108 (1970) & 137C (1971).

¹²⁰ CAL. CORP. CODE §§ 25102(h)(3)(i) & (ii) (West 1977).

¹²¹ *Id.* § 25102(h)(3)(ii).

¹²² *Id.* § 25102(h)(3)(iv).

¹²³ See note 119 *supra*.

¹²⁴ A letter from James D. Irvin, Department of Corporations' Operations Officer states, "Our current procedures are to prepare a receipt for accompanying filing fees and place the document in our filing system. No review of document

clerk reviewed the submission for non-compliance and, if deficiencies were found, the Department sent a deficiency letter to the issuing party.¹²⁵ According to an official at the Department of Corporations, this former procedure revealed deficiencies in approximately twenty percent of the total small offering exemption filings.¹²⁶ Arguably, the Department allows some similar percentage of current filings to stand even though they are non-compliant. The Department should implement a review system which would discover these non-compliant filings. This expanded review could be achieved by reallocating some personnel resources currently reviewing permit applications.¹²⁷ Without a review procedure, there is no assurance that issuers are satisfying the exemption's requirements.

This opportunity for evading the exemption's requirements undermines the policy of protecting the innocent investor. The likelihood that corporations are issuing section 25102(h) securities without the required attorney's opinion¹²⁸ vitiates one of the investor's principal protections. The investor needs this pro-

content is made." Letter from James D. Irvin, Cal. Dep't of Corporations Operations Officer to author (February 21, 1980) (on file at U.C. DAVIS L. REV.).

¹²⁵ The letter from Mr. Irvin states, "Prior to July, 1979 . . . we reviewed the document to insure that required information was provided. If data was omitted, or if there were questions concerning the timely filing of the document, a letter was directed to the applicant to advise him/her of such errors." Mr. Irvin gave the need to reduce operating expenses as the explanation for the change in procedure. *Id.* (A copy of the deficiency letter form which the Department of Corporations used is on file at the U.C. DAVIS L. REV.) The effect of such a deficiency finding was to make the status of the issuance as if the filing had not been made. Thus, the exemption was not available at the time of the deficient filing.

¹²⁶ Letter from Don Loffing, Program Technician, Dep't of Corporations to author (on file at U.C. DAVIS L. REV.). The percentage figure is based on an estimate from filings with the San Francisco office of the Department of Corporations. Mr. Loffing states that the most common deficiencies were "date of execution, place of execution, 10 day filing, and signature of counsel omitted." *Id.* While not a formal study, this letter does give some indication of the frequency of non-compliant filings.

These omissions are serious deviations from the exemption's requirements. The counsel's opinion is a substantive guarantee of the exemption. Likewise, a violation of the ten day filing period is a substantive non-compliance with the statutory scheme. This could allow stock to be issued long before there was any attempt to conform to the legislated requirements of the exemption.

¹²⁷ See note 137 and accompanying text *infra*.

¹²⁸ See note 126 *supra*.

tection. It can only be realized by ensuring that the issuance meets the substantive requirements of the exemption. The attorney's opinion is the first step in this process. A review system would further ensure that the exemption's safeguards are complied with.

A review procedure will also benefit the issuer by helping to prevent two problems for the non-compliant issuer. First, a non-compliant issuer is exposed to liability from any person acquiring the securities from the issuer.¹²⁹ Second, an issuer will face time-consuming and costly procedures to cure non-compliance later.¹³⁰ The issuer may need to cure the non-compliance, for example, should it later want to merge the corporation with another. Issuers can avoid both of these problems if the Corporations Department informs them of any deficiencies under the exemption at the time of filing. The Department must set up a review to uncover such deficiencies.

III. PROPOSALS

The small offering exemption is a major part of the California securities regulation scheme. Unfortunately, section 25102(h) inhibits realization of the statute's objectives. At the same time,

¹²⁹ An improperly exempted issue would not meet the requirements for qualification. See text accompanying notes 22-46 *supra*, for a discussion of the qualification requirements. Securities issued without having been qualified expose the issuer to specified liabilities. The purchaser may rescind the transaction and recover his/her consideration plus interest. If (s)he has disposed of the securities, (s)he may recover the difference between (a) his/her purchase price or the value of the consideration given, plus interest and (b) the securities' value when disposed of plus any income received. There is no liability to subsequent purchasers of the securities. Their cause of action would be against their vendor. CAL. CORP. CODE § 25503 (West 1977). See 1 H. MARSH & R. VOLK, *supra* note 1, at § 14.06(4).

¹³⁰ There are two ways of curing non-compliance. One is to let the statute of limitation run out. The statute of limitation for a violation of the qualification requirements is either two years from the time of actual violation or one year from the discovery by the plaintiff of the violation, whichever comes first. CAL. CORP. CODE § 25507(a)(West 1977). The alternative method of curing non-compliance is a repurchase offer and resale. *Id.* § 25507(b) & (c). Under this procedure, the issuing corporation makes a written offer to the shareholders stating the respect in which liability may have arisen and offering to repurchase the securities. The code imposes certain conditions on this offer. *Id.* The corporation may then re-issue the shares to the same issuees, either under § 25102(h) (if the deficiency can be cured) or through qualification.

the lack of a review system nullifies the exemption's protective measures. The legislature should change the statutory language; the Department of Corporations should revise the administrative regulations and its administration of the exemption. All these changes should make section 25102(h) more harmonious with the needs of small issuers, while protecting the investor.¹³¹

All the proposed changes, except the governmental review, will expand the small issuer's ability to use the exemption. The current exemption contains six important safeguards which enable these changes to be made without leaving the investor unprotected. First, because all shares must be voting common stock, the statute ensures that investors will have some voice in selecting those who run the corporation. Second, California's unique¹³² opinion of counsel requirement ensures¹³³ that an attorney, under threat of personal liability,¹³⁴ will review the

¹³¹ These changes, briefly, are (1) to raise the number of allowable shareholders from 10 to 25; (2) to allow close corporations with shareholder agreements to utilize the § 25102(h) exemption; (3) to conform the small offering exemption's method of counting shareholders to that of § 158; (4) to add an additional consideration alternative where all shareholders consent to the arrangement; and (5) to reinstitute the review by the Dep't of Corporations of § 25102(h) notices. See text accompanying notes 136-147 *infra*, for the discussion of these proposals.

¹³² The opinion of counsel requirement is the only one of its kind in any state's analogous limited offering exemption. For a complete list of all states' limited offering exemptions, see note 87 *supra*.

¹³³ Clearly, the attorney's opinion ensures this review only if it is actually signed. The review procedure proposed here would help secure this compliance.

¹³⁴ There might be attorney liability to the issuer or to the issuee. The issuer might sue, for example, if the exemption were actually unavailable despite the attorney's opinion. The purchasers could rescind the transaction (see note 129 *supra*) and the issuer could have a cause of action against the attorney for breach of duty. The standard of care which the attorney would be held to might be higher than if there were no counsel opinion requirement in the exemption. This is because (s)he signed a statement specifically saying that the exemption was available. See generally, Ziskin, *California's Expanded Close-Corporation Exemption and the Lawyer's Role Thereunder*, 49 CAL. ST. BAR. J. 248 (1974).

The issuee might sue the attorney if the exemption were subsequently found to be unavailable. This would leave the stock unqualified and unexempted. The rule for attorney malpractice liability to third parties in California was set down in *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958) and *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961). A full discussion of this point is beyond the scope of this comment.

transaction. Third, the transfer restrictions give the Commissioner limited control over the transactions subsequent to the stock's issuance. They help ensure that issuees are purchasing for investment rather than resale,¹³⁵ while protecting subsequent purchasers. Fourth, the advertising and selling expense prohibitions control the manner of distribution. Fifth, the restriction on promotional consideration limits the benefit that the corporation's founders or organizers can derive from such endeavors. This ensures that such persons will not take advantage of their position to gain a disproportionately large corporate interest relative to the other shareholders. Sixth, the Commissioner's review of the filing provides adequate assurance of an issuer's compliance with the exemption's requirements. This review increases the effectiveness of all of the exemption's safeguards.

The safeguards' protective qualities allow the enactment of the proposals. Generally, no single safeguard is more critical than any other for a given proposal.¹³⁶ Each safeguard will play some role in protecting the investor. For example, many safeguards are important if the legislature adopts the full consent exception to the consideration requirements. Should the issue be non-compliant, the fact that the signing attorney is available as a party in a civil suit will help protect the new investor. The voting common stock requirement gives shareholders a voice in corporate control. The Commissioner's review ensures that an issuance under the new consideration category will not fail because of non-compliance with the exemption requirements. Such safeguards protect the investor, allowing implementation of the proposals without sacrificing the exemption's protective goal.

The legislature should amend section 25102(h) to increase the maximum number of shareholders from ten to twenty-five.¹³⁷

¹³⁵ If the purchaser sells quickly, (s)he is acting as an underwriter. (S)he is possibly reaping short-term profits which could have been received by the corporation had the shares been purchased by someone buying for investment. The issuing corporation may thus not be getting full value for the issued securities when they are purchased for resale.

¹³⁶ However, there is one case where this is not true. The voting common stock requirement is an important safeguard for allowing an increase in the number of shareholders. It ensures that each shareholder will have a voice in corporate control, even with the larger number of possible shareholders.

¹³⁷ California raised this limit once before. In 1973, the legislature raised it from five to ten. See note 83 *supra*. Raising the number under § 25102(h) could be done in conjunction with raising the number of owners allowed under

This would give the small issuer a large investment pool and ease problems of capital formation for the small business. As an added benefit, this change would free Corporations Department resources from reviewing otherwise eligible qualification applications with eleven to twenty-five shareholders. These resources could then be utilized to provide review of the section 25102(h) notices filed with the Department.¹³⁸ The safeguards of the exemption,¹³⁹ especially the voting common stock requirements, adequately protect the increased number of investors.

The purpose underlying the exemption will also be furthered

close corporation status. This would keep these numbers the same, thus providing coordination between these two sections.

The merits of raising the number of shareholders allowed under § 158 (a) are beyond the scope of this comment. However, the limit of 10 shareholders for California closed corporations has been criticized. One commentator called the limit to 10 shareholders for close corporations "the most troublesome of the statutory requirements" and "is the lowest of any statute, and is in fact highly restrictive." S. SIEGEL, *CURRENT PROBLEMS IN CORPORATIONS AND FINANCE* 14 (Cal. Cont. Bar Educ. 1977). For example, Texas close corporations can have up to 35 shareholders. TEX. BUS. CORP. ACT ANN. art 2.30-1(A)(4) (Vernon Supp. 1980). Close corporations in Pennsylvania and Delaware can have up to 30 shareholders. PA. STAT. ANN. tit. 15, § 1372A(1) (Purdon Supp. 1979-80); DEL. CODE ANN. tit. 8, § 342(a)(1) (1975).

¹³⁸ When the number of allowable shareholders was raised from five to ten, the number of qualifications declined. The change was effective January 1, 1974.

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>
Total Qualifications Issued or Effective	7,619	7,907	6,806	5,469	4,905	5,080
Total § 25102(h) Notices Filed	13,784	15,090	15,897	16,057	16,049	19,474

Source: Dept. of Corporations Reports of Activities for January 1, 1973 to June 30, 1973; July 1, 1973 to December 31, 1973; January 1, 1975 to June 30, 1975; July 1, 1975 to December 31, 1975; January 1, 1978 to June 30, 1978; and July 1, 1978 to December 31, 1978.

This is a total of 22,332 qualifications for the three years before the change and 15,454 for the three years after the change, or a 30.8% decline. A similar effect would be expected in raising the allowable level from 10 to 25, though perhaps not as great. Other factors, such as prevailing economic conditions, may have contributed to this decline. However, the number of § 25102(h) filings rose from 44,771 for the three years before the change to 51,590 for the three years after the change, or a 15.2% increase. This may indicate that some of those who would have had to qualify before the change were able to utilize § 25102(h) after the change.

¹³⁹ See text accompanying notes 131-135 *supra*.

by abandoning the Commissioner's position that shareholders agreements varying rights among shareholders constitute a second class of stock.¹⁴⁰ Currently, if a prohibited shareholder agreement is necessary for corporate management reasons, section 25102(h) prohibits a § 158 corporation from issuing exempted stock. The Commissioner should promulgate an administrative ruling explicitly allowing such arrangements. The ruling will enable more close corporations to issue stock under § 25102(h). This result will further realization of the statutory objective of enhancing small business' ability to issue securities.

Further, the Commissioner should amend the administrative code¹⁴¹ to conform the methods of counting shareholders under the small offering exemption to those of the close corporation. For example, a partnership would then count as one shareholder, unless the partnership were formed to acquire the shares. This change would result in less confusion and less attorney time spent in conforming to the law. The change supports the exemption's policy of encouraging the small business to issue securities. It would still prevent the circumvention of the numerical limit, since the close corporation provision precludes purchase by ownership entities set up for the purpose of acquiring shares.¹⁴²

Additionally, the legislature should add an exception to the consideration restrictions where all shareholders consent to such an arrangement. The current consideration provisions unnecessarily foreclose the exemption's use in many typical small business situations.¹⁴³ Therefore, the legislature should amend section 25102(h) by adding a fifth alternative to the types of eligible consideration which states: "any legal consideration where consent in writing by all shareholders is transmitted to the Commissioner within ten days of receipt of such consideration." This addition would allow many currently ineligible small businesses to utilize the exemption.

An analogous consent arrangement exists in section 25102(h)'s existing consideration restrictions. Where a corporation with outstanding securities issues stock, it can issue more shares for

¹⁴⁰ Cal. Admin. Code, tit. 10, § 260.102.4. See text accompanying notes 96-102 *supra*.

¹⁴¹ See Cal. Admin. Code, tit. 10, § 260.102.5.

¹⁴² See text accompanying notes 88-95 *supra*.

¹⁴³ See text accompanying notes 109-123 *supra*.

cash to existing shareholders.¹⁴⁴ All existing shareholders must approve the sale in writing.¹⁴⁵ The dilution effect on shareholder interest will be the same whether the shares are issued to new or existing shareholders. There is no justifiable basis for distinguishing between these two cases where the shareholders give full written consent.¹⁴⁶ Such a "full consent exception" will allow use of the small offering exemption in situations where the issuer cannot meet the existing consideration restrictions. The exception would afford investor protection by giving shareholders veto power over the corporation's securities sales.

Another needed change involves implementing a review procedure for section 25102(h) filing. The system as it now stands leaves the investor without the protection of the statutory scheme because the Commissioner may not detect non-compliance. Consequently, there is an increased likelihood of non-complaint filings by issuers. Where an issuer does not adhere to the exemption's safeguards, section 25102(h)'s goal of protecting innocent investors is frustrated. The Department of Corporations should institute an effective review system.¹⁴⁷ The Department should return to the previous practice of reviewing each notice upon arrival. A clerk should check each notice for errors and omissions. The Department should then send out deficiency

¹⁴⁴ CAL. CORP. CODE § 25102(h)(3)(iii) (West 1977).

¹⁴⁵ *Id.*

¹⁴⁶ Promotional shares should be allowed under the proposed full consent exception in accordance with the guidelines currently set forth for such shares in qualified transactions. Cal. Admin. Code, tit. 10, § 260.140.31.

"In connection with the financing of an unseasoned corporation, a number of promotional shares (considered in conjunction with any selling expense paid to promoters) may be issued which is not unreasonable. A number of promotional shares which does not exceed 25 percent of all the common shares issued and proposed to be issued by the corporation is presumptively reasonable. However, additional promotional shares may be authorized in light of the services rendered and other consideration given to the corporation by the promoters, the nature and circumstances of the business enterprise being promoted, and the identify of the investors. Normally, no promotional shares may be issued in connection with the financing of a seasoned corporation."

Id. Since, under the § 25102(h) procedure, there is no review to determine the reasonableness of the arrangement, the Commissioner should promulgate an administrative ruling under the full consent exception limiting promotional consideration to 25% of the shares issued and proposed to be issued.

¹⁴⁷ See text accompanying notes 124-130 *supra*.

letters for those filings which evidence non-compliance. This would alleviate the problems caused by the current lack of review and enhance the protection of investors.

A necessary drawback of the increased review is the potential increased cost to the Corporations Department. As stated earlier, this increased cost will be offset with the implementation of an increase in the allowable shareholders to twenty-five. The Commissioner should allocate personnel formerly reviewing the qualification applications with eleven to twenty-five shareholders¹⁴⁸ to review the section 25102(h) filings.

These proposed changes should carefully re-strike the balance between enhancing small business' ability to issue shares and protecting the investor. For example, the proposed increase in the number of shareholders enhances small business' ability to issue more shares. The proposed change ensuring that ownership entities are not established for the purpose of acquiring shares balances the proposed increase in shares. This proposed change, coupled with existing safeguards, will serve to protect the investor. If only the shareholder increase change were made, the statute would fail to delicately balance these interests. Accordingly, the changes are a comprehensive package which should be adopted in its entirety.

CONCLUSION

California enacted a new securities law in 1968. As part of this new law, the state created the small offering exemption to relieve small securities issues from the rigors of qualification. The legislature designed section 25102(h) to aid the small issuer of securities while protecting the innocent investor. Yet, in many situations, the exemption hinders small businesses trying to issue securities. As a result, the law either forces the small issuer to qualify the issue, with additional expenditure of time and money, or prevents the small issuer from raising money through securities issuance. Moreover, the current absence of any review procedure jeopardizes the investor safeguards contained in the exemption.

The legislature and the Corporations Commissioner need to expand the usefulness of the exemption through needed changes

¹⁴⁸ This would include, of course, only those who meet the other provisions of section 25102(h).

in the exemption and its administration. The legislature should amend the statute to increase the number of allowable shareholders and add a new category of eligible consideration. The legislature and the Commissioner should conform the exemption's methods of counting shareholders to that of the close corporation provision. The Corporations Commissioner needs to establish a system for reviewing section 25102(h) filings. Additionally, the Commissioner should change the Administration Code to allow close corporations with certain shareholders agreements to use the exemption. The exemption's existing safeguards should be kept intact. These changes should facilitate small business capital formation while ensuring protection of the investor.

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