The California Corporate Securities Act*
(CONTINUED)

SECTION 3. ADMINISTRATION OF SALE OF SECURITIES IN A CLOSED MARKET

(1) INTRODUCTION

The administration of the securities act in California indicates a small number of cases in which applicant corporations have been denied a permit to sell their securities. The regulative power given the Commissioner is not so much exercised in prohibiting the sale of securities as it is exercised in conditioning sale by “terms and conditions.” Rules have been evolved in the administration of the act, by the Commissioner, which are deemed “reasonable and necessary to carry out the purposes and provisions of the act.”

The Department permits withdrawals rather than to enter denials of applications in all cases where it feels that the effort is an honest one, but the set up or other matters were out of line with its policy, reserving denials for those matters which it considers fraudulent.

It should be remembered that the labors of the author covered only one month of operation of the Corporation Department. An examination of the records of permits issued can not disclose the very important work done by the deputy commissioners in their conferences with the attorney for the applicant corporation and with the promoter and officers of the corporation. Numerous irregularities, legal defects, and financial defects are straightened out in these conferences before the permits are written. This achievement should be given due emphasis. Hundreds of attorneys and clients of the attorneys will testify to the cooperation, aid and benefit received at these conferences. This in part explains the reason for the few denials of the applications. The application is rearranged to meet the policies of a fair, just and equitable permit or if not so rearranged the scheme is abandoned by the applicant voluntarily withdrawing the application.

An actual analysis of the time consumed in issuing permits upon applications will disclose a large portion of the time consumed in

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* This is the second installment of this article, the first having appeared in the January issue of this Review. 18 CALIF. L. REV. 115.

35 For rules and regulations of the Department, see FRIEDLANDER, ADMINISTRATION OF CORPORATE SECURITIES ACT (Aug. 17, 1927); ATHEARN, RULES OF PRACTICE BEFORE STATE CORPORATION DEPARTMENT (June 17, 1929).
awaiting further legal documents from the attorney, or corrected financial statements or analyses from the applicant. Attorneys may delay several weeks in filing an application and advise their clients, the applicants, that the delay is in the Corporation Department when in fact the application had not been filed by the attorney.

The "Rules of Practice" and "Outline of Functions" of the Corporation Commission which were prepared by Commissioner of Corporations Fred G. Athearn and published during June, 1929, indicate considerable changes in policies, organization, and efficiency.

For the purpose of this study the various types of securities which are being sold currently to the investing public through various types and kinds of brokers may be divided into two groups: first, those issued and sold by a local corporation under a permit from the Corporation Department, and second, those securities issued and sold by foreign corporations outside the state to be resold, without a permit, by licensed brokers within the state.

(2) **Nature of a Closed Market**

Securities sold by local corporations under a permit from the Department may be divided into two groups: those sold to a closed market, and those sold to an open market or sold to the general public. This section discusses the nature, extent and regulation of securities sold in a closed market.

The outstanding characteristic of securities sold in a closed market is the fact that they are not offered to the general public. It should be noted immediately that the securities of this type are the most numerous and that the greater part of the administrative work of the Department is consumed in the examination of their applications and checking their subsequent, post-permit history. In the month of March, 1928, there were 477 permits of all types issued by the Department allowing the sale of securities. Of this number there were 347 permits, about 70 per cent, which limited the sale to a closed market, forbidding it to the general public.

36 The biennial report of the Corporation Department does not list the permits issued to corporations to sell their securities. These permits are bound in Books of Records. These records include every permit, order, license, denial, amendment made by the Department covering companies, agents, brokers, escrows, impounds and the numerous other departmental subjects. In order to study the nature of the permits issued in a sample period, March, 1928, it was necessary to examine 1,857 documents in the Book of Records for that month, 477 of these were permits. These permits give a summary description of the corporation and the conditions upon which it may sell its securities. In case of "closed permits" the summary was inadequate for purposes of this study and a scrutiny of the detailed documents and correspondence on the cases was necessitated.
The securities of this type are sold without a commission being paid to any broker or agent. The sponsor of the venture has a list of persons to whom he can sell the stock if a permit is obtained. This list is filed with the application. The sale is made by the officers of the corporation and this sale, by the provisions of the permit, shall "net the applicant the full amount of the selling price thereof."

(3) Classes of Purchasers of Securities Issued for a Closed Market

The kinds of purchasers of the securities sold without a selling commission and to a closed market is indicated by the following schedule:

Prospective Customers of Stock Issued by Corporations in a Closed Market — March, 1928

<table>
<thead>
<tr>
<th>Category</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Persons named in application</td>
<td>269</td>
</tr>
<tr>
<td>Stockholders of Corporation</td>
<td>42</td>
</tr>
<tr>
<td>Another Corporation</td>
<td>24</td>
</tr>
<tr>
<td>Creditors of Corporation</td>
<td>6</td>
</tr>
<tr>
<td>Partners</td>
<td>2</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>347</td>
</tr>
</tbody>
</table>

A. Persons Named in Application.

In this class of permit the applicant enumerates the persons to whom the security is to be sold, when, as and if a permit is obtained from the Department. In the majority of these cases, 232 out of 269, the number of persons listed was 10 or less. A further analysis indicates that of these 232 cases about 75 per cent have been granted a permit to sell stock to two, three, four or five persons.\(^{37}\)

B. Stockholders of Corporation.

In this group the sale is made to stockholders of the selling corporations. It is similar to the "persons named group" in that the application ordinarily contains a list of stockholders.\(^{38}\)

C. Another Corporation.

In 24 cases permits were granted to an applicant to issue its securi-

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\(^{37}\) Under the provisions of Massachusetts, Pennsylvania and Wisconsin and states having the Uniform Security Act, exemption would be allowed those corporations having 25 or less stockholders.

\(^{38}\) Under the provisions of the Acts of Massachusetts, Illinois and Pennsylvania (and other states), such a sale would be exempted.
ties to another corporation in exchange for stock or assets of that corporation.39

D. Creditors of Corporation.

This group, six cases, issued corporate securities to creditors in view of cancellation of indebtedness. This generally takes place at the time of a reorganization and the plan of reorganization is outlined in full as a part of the application.40

E. Partners and Miscellaneous.

Six cases held two in which a partnership wished to incorporate by issuing stock for the respective partner's interest in the business.

A detailed examination of the 477 permits issued during March, 1928, indicates that 347 were issued for a closed market without commissions being paid in such sales. The names of the purchasers of these securities under the permits were placed before the Commissioner at the time of application and these persons knew, presumably, the nature of the security which they were purchasing. It is the general rule in other large states to exempt securities to be sold in a closed market by reason of the absence of the incentive of profitable fraud through commissions and the presence of information about the security in the minds of the purchasers.

(4) Policy of Department as Reflected in Permits for Closed Market Sales

The nature of the written permit granted by the Commissioner to applicant corporations may vary from a simple statement, allowing the sale without conditions or provisions, to a lengthy, complex document reciting numerous conditions under which the sale is made. The "open permit," which allows the securities to be sold to the public, must be shown to each purchaser at the time of the solicitation. The "closed permit" need not be presented to the purchaser. The administrative policy of the Corporation Department in the cases of "closed sales" may be examined best by a study of the typical transactions involved in such sales. They are as follows:

A. Issuance of Qualifying Shares.

There are numerous cases in which applicant corporations prayed to issue qualifying shares to its incorporators. This is done preparatory to the issuance of its securities for assets at a future date, when, for

39 Exempt by Utah, Indiana and Virginia and states subscribing to the principles of the Uniform Securities Act.
40 Exempt in Wisconsin and other states.
example, an option for purchase of real property is taken up.\textsuperscript{41} In many cases corporations issue qualifying shares before a permit is obtained granting this permission. At the time of the filing of a supplementary application, this fact of the illegal issuance is disclosed and the Department requires, as one of the conditions in the supplementary permit, that the illegally issued qualification shares be cancelled and "permitted" shares be issued in their place.

\textbf{B. Issuance of Shares in Exchange for Property.}

The most frequent application placed before the Department is one asking for a permit to issue shares in exchange for property. Stock is not sold to the public nor issued for cash, nor sold on a commission, but is exchanged for the assets making up the business of a partnership or a single owner. This includes the incorporation of retail stores, service stations, garages and innumerable small establishments. It is this type of incorporation which explains the great number (a majority) of the applications making two or three incorporators the purchasers of stock for property.

In this type of transaction, no conditions are imposed upon the corporation by the terms of the permit. The small size of the venture, the few purchasers of stock, are deemed to make this unnecessary. The examination of the venture, prior to the issuance of a permit, includes an examination of articles of incorporation (and by-laws) as to their legality and an examination of the history of the business and its management. The examination of the business history is made through a commercial agency, that of the management through the Department's question list.\textsuperscript{42} In addition to this, the Department checks the value of the property as submitted by the applicant. In small ventures the only feasible means of doing this is to take the book value of the property as the basis of the value of the stock to be issued. These

\textsuperscript{41} This type of application requires the minimum of information to be filed according to section 3 of Act.

1. Application by law.
2. Sworn statement by secretary of corporation that application is true.
3. Copy of articles of incorporation.
4. Copy of certificate of stock.
5. Copy of by-laws.
6. Minutes of director's meeting in which resolution was made that application be filed.

\textsuperscript{42} The Department's question list is a list, made primarily from newspaper clippings, of persons who have been put under surveillance because of their activity in some fraudulent or questionable financial deal. It is the Department's Rogue Gallery. If an applicant corporation submits the name of some person on the question list as officer or stockholder, the Department asks that that person sever his connection with the corporation unless he can show evidence that his record is unblemished.
figures, however, are submitted by the applicant, unchecked by a public accountant.

The property of a partnership or proprietor, to be absorbed by a closed corporation, is often transferred for stock subject to its business liabilities. The typical permit reads, “A. B. C. Company, a California corporation, is hereby authorized to sell and issue 20,000 shares of its capital stock as herein below set forth: To issue shares of its capital stock to A and B and C not to exceed in the aggregate to either or both 15,000 shares, in exchange for the business and assets described in its application, first to be assigned and transferred to applicant, subject to liabilities not exceeding in the aggregate $10,000.”

C. Issuance of Stock for Property, Cash and Services.

The next class of securities sold under a closed permit are those of new (or previously incorporated) corporations issuing stock to individuals, for property, a sale of a small block of stock to enumerated persons for cash, and an issuance of stock for services. Unlike the class above, in which incorporation is undertaken for the primary purpose of changing the form of ownership, these cases are those in which a property owner, or owners, incorporate for a financial reason; for example, to raise funds through the sale of stock or to start a business venture with his property as a basis. The organizer’s friends, employees or business associates are sought out to contribute funds. He contributes either funds, property, patents or goodwill.

The sale of stock is to persons named in the application and the sale takes place without a commission. The organizer may reap his reward by putting the business on a profitable basis. The promotion, however, is different basically from that involved in a public sale of stock in that the named purchasers have knowledge of the risks inherent in the business. These purchasers live in the same community with the organizer and know his reputation as a manager; likewise they are familiar with the property involved, often as employees, bankers or creditors of the organizer.

The examination of this type of application by the Department involves the preliminary checking of the business history of the management and the financial statement, including a profit and loss statement, where this is available. As property of a debatable value is often involved, appraisals are requested by the Commissioner. The heart of the examination, however, centers about the valuation of the property or services contributed by the organizer. If the property is real estate and of tangible value, it is appraised; if it is a going concern it is valued by its net worth. Often, however, goodwill is included and
if this item is in excess of a reasonable capitalization of earning, the stock issued for the goodwill is escrowed. This escrow provision allows an issue of stock to the organizer, but this stock cannot be sold or transferred by him until permission is gained from the Department, often by submission of a formal application praying for the same. This permission is granted, as and if the assets exchanged for the escrowed stock prove to be of the value represented at the time of the sale.

In addition to the escrow of organizer's stock issued for intangibles, there are two other provisions commonly written in permits of closed corporations, financial reports and transfer agents. A financial report provision in a permit requires that a financial statement be submitted at intervals stated by the Department; in the case of closed corporations that interval is 12 months, generally. The transfer agent clause is required, "whenever the commission deems it advisable so to do," and this means generally when the issue of stock is sizable, say over $50,000. By provisions of this clause, the transfer agent, appointed by the corporation and approved by the Department, is to issue and transfer the stock of the corporation and to keep a record of the same for an immediate inspection by officers of the Department. This does not entail an expense to the corporation, as it is customary to appoint its secretary or legal counsel to act as its transfer agent.

The following schedule indicates the nature and extent of the use of conditions in permits allowing the sale of corporate securities in a closed market:

<table>
<thead>
<tr>
<th>Description</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Closed Permits Issued March, 1928</td>
<td>347</td>
</tr>
<tr>
<td>Number of Closed Permits having one or more</td>
<td>167</td>
</tr>
<tr>
<td>conditions</td>
<td></td>
</tr>
<tr>
<td>Number having Financial report condition</td>
<td>134</td>
</tr>
<tr>
<td>Number having agent condition</td>
<td>133</td>
</tr>
<tr>
<td>Number having escrow conditions</td>
<td>103</td>
</tr>
</tbody>
</table>

Of the total number of closed permits issued, 167 or 48 per cent had one or more conditions, the remainder were permits issued in those cases in which the corporation issued qualifying shares or those in which there was incorporation to change the form of ownership in a small business with the proprietor and a few associates becoming the stockholders. Of the 167 cases with one or more conditions, there were 167 cases with the requirement for a transfer agent and financial report. A smaller number, 103, required the escrow of stock issued for assets, either property, business, service or process, which had an intangible

43 The greatest number of escrows were for services, the next for property, and the least for patents. There were only 6 cases of escrow of patents out of 103 escrows. As a rule, the exploitation of processes or patents involves a public sale of stock.
value. The Department no longer inserts in any permit, either open or closed, the financial report condition, and has abandoned the transfer agent condition in closed permits. The transfer agent and registrar condition is used only in public sale, or so-called “open” permits. The Department now inspects the books of a company operating under a license, or at frequent intervals calls for whatever information it may deem advisable.

D. Issuance of Stock to Present Stockholders.

A going corporation, desiring to raise new capital, will usually seek to raise this capital from its present stockholders. The sale can be made with less expense than by any method of selling directly or indirectly to the public with brokers and agents commissions. Sales of stock by a corporation to its own stockholders are sales to a closed market, although the list of stockholders is not required to be submitted to the Commissioner at the time of the application.44 The application need merely set forth that the proposed sale is to be limited to the shareholders of the applicant company or of other companies. (The practice of submitting a stockholders’ list was abandoned some years ago.)

The financial condition of the corporation at the time of the application to issue securities to stockholders varies from one of incipient insolvency to one of sound financial condition, both as to assets and earnings. The regulation of the further sale of stock by a weakened corporation is not greatly different from that of a newly organized promotional venture.

Generally speaking, the Department assumes the position that the sale to stockholders is to be regulated “in order that the dealings between a corporation and its stockholders be equitable.”45 The regulation is based upon the assumption that the interests of the corporation are not those of its stockholders and that the control of the corporation by the stockholders, exercised through the customary channels provided for by law, must be supplemented by regulation of the Department. This regulation is expressed in one or both of two ways:

(1) Regulation of the price of the stock to be sold. — It is customary for the Department to examine carefully the price asked for the stock to be sold by a corporation to its stockholders. This asked price is checked by one or all of three methods. First in a few cases where the corporation’s shares are listed on an exchange this price offers a measure to gauge the fairness of the asked price as stated in

44 This does not hold of course in case of the few corporations having thousands of stockholders.
45 Freedlander, op. cit. supra n. 35, 49.
the application. Obviously this does not entail any great difficulty, as
the asked price could not be greater than the price in the open mar-
ket. In most cases this quotation is not present. Secondly, the
auditors of the Department check the book value of the shares out-
standing, plus those to be issued. The resultant figure is used in com-
parison with the asked price. Thirdly, the earnings of the company
are averaged over a period of years and are capitalized at the customary
rate of capitalization within that kind of business. This capitalization
of average earnings is resorted to in those cases in which the corpora-
tion asks to sell its securities at a higher price than the book value per
share.\textsuperscript{47}

\textbf{(2) Pro Rata Conditions.}—By the terms of this condition, the
Department requires the new issue of stock to be offered to the stock-
holder in the proportion of the amount each holds to the total number
of new shares to be issued. A further provision is made in case the
rights to purchase are not taken up by the present stockholders as out-
lined above. That provision is, “Fifteen days (more or less) after such
offer shall be made in writing to such stockholders of the exercise of
the rights herein given to be subscribed for said shares, any shares re-
main ing unsubscribed for may be offered and sold to any other stock-
holders of said company, or to the public for the considerations herein-
before recited.\textsuperscript{48}

The discussion above is largely in regard to a sale of stock to
present stockholders. Often the sale is made partly to the public if the
needed capital is not furnished from within the present list of stock-
holders. It should be realized that expansion of a going corporation
often is brought about by an exchange of stock for property, by ex-
change of stock for stock of another corporation or by a small public
sale supplementary to the closed one. In order to understand the varied
reasons and conditions for which stock is issued by an active expanding
corporation an outline history is given of the “Blank Corporation,” a
holding and operating company in the manufacturing of a fabricated,
industrial material in California. Although it is of considerable size and

\textsuperscript{46} By the amended provisions of section 2, the issuance of rights, pertaining
to a security and entitling the holder of such right to subscribe to another security
of the same company “shall not be deemed to be a sale, no permits necessary for
their issuance, but the sale of such other security upon the exercise of such right
shall be subject to the provision of this act.”

\textsuperscript{47} In those cases in which the corporation expands its operation by the issu-
ance of new stock for property the Department requires that the value be appraised
by persons satisfactory to it. It is usual to find, of course, an issuance of a new
block of stock, a part of which is issued for property, a part issued to old stock-
holders for cash, and part to the public.

\textsuperscript{48} \textit{Friedlander, op. cit. supra} n. 35, 39.
financial strength, it has not raised its funds from the public, but has accomplished this through sale of new blocks of stock to its stockholders, numbering less than 200. Its stock is listed upon a local exchange, but the total shares dealt in are but a small proportion of the total, the holders of the stock are few and permanent.

<table>
<thead>
<tr>
<th>PERMITS DATED</th>
<th>PURPOSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>January, 1925</td>
<td>Qualifying shares to Incorporators.</td>
</tr>
<tr>
<td>June, 1925</td>
<td>Shares issued to absorb assets of five companies.</td>
</tr>
<tr>
<td>April, 1925</td>
<td>Sale of shares to stockholders at $100.</td>
</tr>
<tr>
<td>June, 1926</td>
<td>Sale of shares to stockholders at $150.</td>
</tr>
<tr>
<td>December, 1926</td>
<td>Shares issued to absorb company.</td>
</tr>
<tr>
<td>February, 1927</td>
<td>Sale of shares to stockholders at $250. At same time permit of June, 1925, revoked.</td>
</tr>
<tr>
<td>June, 1927</td>
<td>Stock split 4 to 1; new share sold $62.50. At same time permit February, 1927, revoked.</td>
</tr>
<tr>
<td>November, 1927</td>
<td>Change in price of stock to allow preference in sale to employees.</td>
</tr>
<tr>
<td>March, 1928</td>
<td>(a) Change in number of shares and price under permit of November, 1927.</td>
</tr>
<tr>
<td></td>
<td>(b) Change in permit to allow company to issue share with provision of financial statement supplies every 12 months, instead of every 6.</td>
</tr>
<tr>
<td>February, 1929</td>
<td>Issued stock dividends to stockholders.</td>
</tr>
</tbody>
</table>

This example indicates some of the occasions upon which an active corporation may be required to apply for a permit to issue its stock in a closed or semiclosed market. In this case, there were eleven permits issued, three cases allowed sale for cash to stockholders, three to amend permits previously issued, three to issue stock for properties owned by other corporations, one to change selling price, and one to qualify the director. The permits had conditions making it necessary to offer the stock to the existing holders pro rata according to their
holdings and the last permit issued under the rule of Commissioner Friedlander required the appointment of an independent registrar for the stock\textsuperscript{49} and a submission of financial reports every 12 months.\textsuperscript{50}

(5) Recapitulation and Conclusion

About 70 per cent of the corporations applying for a permit to sell their securities request that these securities be sold within a closed market, to the persons named in the application and not to the general public. These securities are sold net for cash or property and without selling commission. With no commissions paid on the stock, there is no active sales organization to effect a wide distribution of the securities. This limits the market to a local one in which the buyers of the securities have the opportunity to learn first-hand the nature of the business venture and the calibre of the management. In most cases, these buyers are limited to from three to five persons; persons closely allied to the management of the corporation, such as creditors, stockholders or a corporation in a merger. The nature of the buyers indicate that they have sufficient knowledge about the corporation's financial and business structure to eliminate fraud and deception which might arise in their purchase of its securities. This position has been taken by all large states, with the possible exception of Michigan, and their security legislation gives exemption to corporations selling their securities in a closed market. This lessens the duties of the administrative offices and allows corporate financing of this type to take place with the minimum of government regulation.\textsuperscript{51}

In the administration of the California Securities Act, the examination of the application for a closed permit is not greatly different from the examination of a promotional corporation selling stock to the general public, in that legality of incorporation proceedings,\textsuperscript{52} valuation of

\textsuperscript{49} This requirement, of course, was met at the time of the listing of the stock on the local exchange. The Department's requirement did not entail a new obligation or duty.

\textsuperscript{50} In 1927 the Department required a financial statement every six months and wrote a permit accordingly. As the company took inventory and closed its books once a year, request was made and granted, that it be allowed to make a yearly report. To do this, the Department issued a new permit and revoked the previous one.

\textsuperscript{51} As the Securities Act is administered in California, the detailed work in examining the application for closed permits entails an expense of at least three times that in other large states.

\textsuperscript{52} Friedlander, \textit{op. cit. supra} n. 35, 14. This examination includes the determination “as to whether the statute to apply in such cases (corporations) is substantially complied with; to inquire as to whether the articles of incorporation, the minutes of the stockholders and directors, and the by-laws, conform with the provisions of the law made in connection therewith.”
assets, and business history of the management are tested before a permit is written. This strict administrative regulation involves delay and expense to the applicant corporation.\(^3\)

\(^3\)Biennial Report of State Corporation Department (1928) 59, 56. It took about one week in 1928 to obtain a closed permit. An open permit can not be handled as easily or as quickly as a closed permit. At the present time it is said that closed permits are handled within about twenty-four hours, which removes the most serious objection to regulatory supervision.

* Instructor, Harvard Graduate School of Business Administration.