Cal Law Trends and Developments

Volume 1967 | Issue 1 Article 3

January 1967

Business Associations

Roland E. Brandel

Follow this and additional works at: http://digitalcommons.law.ggu.edu/callaw

Part of the Business Organizations Law Commons

Recommended Citation
Roland E. Brandel, *Business Associations*, 1967 Cal Law (1967), http://digitalcommons.law.ggu.edu/callaw/vol1967/iss1/3

This Article is brought to you for free and open access by the Academic Journals at GGU Law Digital Commons. It has been accepted for inclusion in Cal Law Trends and Developments by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.

Business Associations

by *Roland E. Brandel**

Because the law governing business associations is in large part codified and subject to administrative regulation, this article will emphasize new legislation and changes in policies of agencies charged with the enforcement of that law. The most sweeping changes were accomplished by regulations issued by the commissioner of corporations, but there were also several noteworthy amendments and additions to statutes affecting corporations. Additionally, major changes to the Corporate Securities Law are now before the legislature[1] and passage of a bill is expected during 1968. Neither space nor time permits a definitive analysis of the multitude of recent

* B.S. 1960, Illinois Institute of Technology; J.D. 1966, University of Chicago Law School. Member, California State Bar. Practicing Attorney, San Francisco.

The author extends his appreciation to Michael Hunter, second year student at Golden Gate College, School of Law, for his assistance in the preparation of this article.

1. Assembly Bill 1 (1968) Reg. Sess. Cal. Legis. (1968). Where topics under discussion below can be related to the proposed legislative revision, an attempt has been made to do so.

Published by GGU Law Digital Commons, 1967

cases involving aspects of the law relating to business associations. Where a case has caused some change in the prior law, however, an attempt has been made to signal that change and to provide some appraisal of the rules of law it promulgates.

The Corporate Entity

As a general rule, a corporation is a distinct legal entity that accumulates rights and incurs liabilities apart from the natural persons, such as directors, officers and shareholders, who are associated with it. The California courts, however, liberally exercise a technique of piercing the corporate veil[2] to reach behind the separate nature of the corporate entity in order to prevent injustice. The court of appeal did so in *Schoenberg v. Koutnik.*[3] The decision held a husband and wife liable under the alter ego theory for the debts of an under-capitalized, but very successful, corporation of which they were the sole shareholders. Because of the under-capitalization and the fact that corporate and personal finances were inextricably intertwined, application of the equitable doctrine that disregards the corporate entity was hardly surprising.[4]

The alter ego theory was also applied, but with a less typical result, in *Ivy v. Plyler.*[5] The defendant, Plyler, was an officer and director of Lupine Oil Operations and operated that corporation in such a manner that application of the doctrine of alter ego was inevitable if an attempted interposition of the liability shield ordinarily provided by the corporate entity portended harm to plaintiff. Plaintiff sued Plyler for amounts due on certain contracts plaintiff had performed for Lupine Oil. Plyler's response was to obtain a discharge in bankruptcy, which he claimed barred suit on the debt. The court held that Plyler was responsible for the corporate debts under the alter ego theory and further that he was guilty of mis-

2. See generally 12 Cal. Jur.2d, Corporations § 8.

3. 251 Cal. App.2d 154, 59 Cal. Rptr. 359 (1967).

4. See Automotriz del Golfo de California v. Resnick, 47 Cal.2d 792, 306 P.2d 1, 63 A.L.R.2d 1042 (1957).

5. 246 Cal. App.2d 678, 54 Cal. Rptr. 894 (1966).

appropriation and defalcation when he withdrew corporate funds for his personal use. Hence, plaintiff's debt was not one dischargeable in bankruptcy under the provisions of section 17(a)(4) of the Bankruptcy Act.[6]

Although the result reached is not unique, it would seem that the route chosen is. The doctrine of alter ego "disregards the corporate entity and holds the individual responsible for acts knowingly and intentionally done in the name of the corporation."[7] The acts of the corporation in incurring the debt, which were attributable to Plyler under this rule, were not those that the Bankruptcy Act singles out as creating nondischargeable debts. Further, Plyler's actions vis-à-vis the corporation, in his fiduciary capacity, did not directly create any debt owed plaintiff. The debt was clearly antecedent to Plyler's breach of fiduciary duty and was created by corporate acts attributable to Plyler by application of the alter ego theory. It can be argued that Plyler's misconduct, if any, occurred in his relationship to the corporation and its property and would create a right of recovery by the corporate entity or one standing in the shoes of the corporation. Most cases involving corporations arising under 17(a)(4) in fact involve recovery by the corporation itself[8] or by a party, such as a receiver,[9] trustee[10] or surety,[11] who

6. 11 U.S.C. § 35(a)(4) (1964).

7. 246 Cal. App.2d at 682, 54 Cal. Rptr. at 897.

8. See Citizens Mut. Automobile Ins. Co. v. Gardner, 315 Mich. 689, 24 N.W. 2d 410 (1946); Airo Supply Co. v. Page, 2 Ill. App.2d 264, 119 N.E.2d 400 (1954).

9. See In re DeGraaf, 22 F.2d 163 (S.D. Mich. [1927]); Harper v. Rankin, 141 F. 626, 72 C.C.A. 320 (4th Cir. [1905]); McNeill v. Savin, 244 Wis. 552, 13 N.W.2d 82 (1944).

10. See In re Hammond, 98 F.2d 703 (2d Cir. [1938]); Kaufman v. Lederfine, 49 F.Supp. 144 (S.D.N.Y. [1943]); Floyd v. Layton, 172 N.C. 64, 89 S.E. 998 (1916); Bannon v. Knauss, 57 Ohio App. 288, 13 N.E.2d 733 (1937).

11. See National Surety Co. v. Wittich, 185 Minn. 321, 240 N.W. 888 (1932); National Surety Co. v. Lanza, 42 N.Y.S.2d 370 (Sup. Ct. 1943). These cases allowed the surety to stand in the corporate creditor's shoes through subrogation (see Johnson v. Mortgage Guar. Co., 117 Cal. App. at 421, 4 P.2d at 210 [1931]), but not all suretyship cases can be thus explained. A second line of suretyship cases can be explained under statutory language, as in the cases arising under the New York Stock Corporation Law, because the act of misappropriation itself created the debt to the surety and hence would be a transaction falling within the literal terms of the Bankruptcy Act. See Hartford Accident & Indem. Co. v.

stands in place of the corporation. Several New York cases have allowed recovery by creditors of a corporate entity against an officer or director. They are atypical, however, and can be explained by the specific provisions of section 15 of the New York Stock Corporation Law, which made the very act of misappropriation or defalcation an act that created a debt owed to the creditors.[12] Such a debt therefore falls precisely within the words of the statute as one "created by [the bankrupt's] fraud, embezzlement, misappropriation, or defalcation while acting as an officer. . . ."[13]

Allowing a claim of a creditor of a corporation to survive the bankruptcy of an officer because of section 17(a)(4) is not without precedent, although none of the precedents involved application of the alter ego doctrine.[14] The decision raises doubt, however, whether its rule is correct in light of the purposes of the Bankruptcy Act; whether defendant's activity was serious misconduct of the type intended to be covered by section 17(a)(4);[15] and whether the recovery should properly have been corporate and therefore for the benefit of all creditors.

As to the alter ego doctrine *per se,* defendant argued in *Ivy* that if he and the corporation were to be treated as one, then he committed no wrong by treating corporate property as his own. Following that argument briefly, one could say that it is not atypical to find that sole proprietorships are incorporated with no contemporaneous change in organization or practices and that the alter ego doctrine properly disregards the corporate existence to protect third parties. It would seem, however, that placing the third party in the position where he has access to all of defendant's personal assets would be sufficient to compensate for defendant's only

Flanagan, 28 F.Supp. at 419 (S.D. Ohio [1939]).

12. In re Bernard, 87 F.2d at 707 (2d Cir. [1937]); In re Adelson, 187 Misc. 691, 65 N.Y.S.2d 162 (Sup. Ct. 1946).

13. 11 U.S.C. § 35 (a)(4) (1964).

14. In re Metz, 6 F.2d 962 (2d Cir. [1925]); Banks v. Corning Bank & Trust Co., 188 Ark. 841, 68 S.W.2d 452 (1934); Tatum v. Leigh, 136 Ga. 791, 72 S.E. 236 (1911).

15. See Cowan, BANKRUPTCY LAW AND PRACTICE, §§ 472, 479 (1963).

real wrong, which was the creation of an illusion of a separate corporate entity where none existed.

If *Ivy* is now good law, one fact is crystal-clear. Incorporation of a small business may not only fail to provide the protection from liability anticipated by creation of the separate entity; it may also cause individuals, in the event their corporate and individual financial affairs fail, to lose the ordinary protections afforded by the Bankruptcy Act. Adopting the corporate form as a form only, while intermingling corporate and personal finances as if the business were still a sole proprietorship, may cause an exposure to risk of unlimited personal liability.

Another case, which denied to a state agency, the State Board of Medical Examiners, the ability to pierce the corporate veil seems to be a retrenchment from the liberal use of the technique evidenced by *Ivy*. Sections 654 and 4080.5 of the Business and Professions Code operate to deny physicians and surgeons licensed to practice in California the right to own or operate pharmacies. These provisions per se and their applicability under particular circumstances were attacked on many grounds, including unconstitutionality, by a host of medical practitioners who, under several different business forms, either operated or desired to operate pharmacies. The court of appeal in *Magan Medical Clinic v. State Board of Medical Examiners*[16] engaged in an extensive analysis of the social evil at which the legislation was directed. Since shady practices might result when a conflict of interest exists between the welfare of patients and economic participation of doctors in lucrative prescription-filling businesses, the court held that the legislation, designed to forestall such a conflict of interest, was constitutional. In response to the argument that the literal language of the legislation prohibited only individuals from having an ownership interest, the court in construing the intent of the statute said:

16. 249 Cal. App.2d 124, 57 Cal. Rptr. 256 (1967).

Published by GGU Law Digital Commons, 1967

> It is obvious that the statute would be completely frustrated if all that was necessary to circumvent the statute was for two doctors to form a partnership, and then operate a pharmacy where neither could . . . operate as such individually.[17]

Such a rationale would seem equally applicable to the case of one or more doctors who use the corporate form to circumvent the prohibition of these statutes. The court did not foreclose that alternative, however, but ruled instead that doctors may own pharmacies through the simple expedient of using the corporate business form.[18] The court deemed itself compelled to interpret the statutes strictly because "the statutes here involve penalties or forfeitures. . . ."[19] The court may also have had some reservations about the constitutionality of a rule that would deprive all doctors of the right to participate in even minor shareholding of such enterprises as large chain drugstores. If the latter were the persuasive factor, either on constitutional or general policy grounds, it might be ventured that a preferable result would be to allow the corporate form to be ignored in those situations where the corporation is merely the alter ego of a small group of physicians or where doctors have clear control over management or disbursement of profits. Those situations must necessarily be within the scope of the statute if the statute is to be effective, but the court might have compromised by stating that corporate ownership per se is not a violation of the statute.[20]

17. 249 Cal. App.2d at 136, 57 Cal. Rptr. at 264.

18. The court reached the same conclusion in a companion case in interpreting the statutory provision (Cal. Bus. & Prof. Code § 4080.5) that prohibited the future licensing of doctors to operate pharmacies. Warrack Med. Center Hosp. v. State Bd. of Pharm., 249 Cal. App.2d 118, 57 Cal. Rptr. 85 (1967). In *Warrack,* however, a clear alternative ground for the decision also existed.

19. 249 Cal. App.2d at 138, 57 Cal. Rptr. at 266. It should be noted here that the legislation was passed in 1963, but did not require physicians who had a prohibited interest in a pharmacy to divest their interest until July 1, 1967. The action here, then, was one for declaratory relief, not for relief from any immediate sanction.

20. Compare the provisions of Cal. Bus. & Prof. Code § 25502, which imposes more carefully drawn restrictions on ownership of liquor sales outlets. The court found the explicitness of that statute an indication that the instant

Another aspect of the corporation as an entity is its existence as a creature of the state. Thus, the state may utilize sanctions, such as suspending or terminating the very existence of the corporation, which are not applicable to natural persons. The California Supreme Court last year mitigated the potentially harsh effects of a suspension of a corporation's powers for failure to pay corporate franchise taxes pursuant to Revenue and Taxation Code section 23301. In *The Traub Company v. Coffee Break Service, Inc.*,[1] the court made clear that since the issue of incapacity of a corporation to sue or defend a suit because of section 23301 was one only of abatement, the section should be strictly construed against the one asserting the incapacity. The specific issue in *Traub* was cross-defendant's contention that a judgment in favor of cross-complainant Coffee Break Service, Inc. could be collaterally attacked because of incapacity based on such a suspension.[2] The court disapproved language in *Belle Vista v. Hassen*,[3] which allowed such a collateral attack, and held that the judgment could not be vacated on such a ground unless the essential facts appeared in the judgment roll. The opinion distinguished those cases where the corporate entity no longer existed.[4]

The court seems to have correctly decided that the legislature did not intend Revenue and Taxation Code section 23301 to operate as a forfeiture of substantive rights by virtue of an inability to defend suits. The "penalty" incurred by such a forfeiture would be totally unrelated to the seriousness of the offense except by coincidence. Rather, the court seems to view the statute's purpose as providing an impetus to rectify tax delinquencies by denying access to the state courts so long as the suspension is in effect.

statute was meant to have a more limited scope. See also Schoenberg v. Koutnik, 251 Cal. App.2d at 167, 59 Cal. Rptr. at 367 (1967).

1. 66 Cal.2d 368, 57 Cal. Rptr. 846, 425 P.2d 790 (1967).

2. See Smith v. Lewis, 211 Cal. at 298, 300, 295 P. at 39 (1930). Both the reasoning of *Traub* and Reed v. Norman, 48 Cal.2d at 343–344, 309 P.2d at 812 (1957) weaken the continuing validity of *Smith*.

3. 227 Cal. App.2d 837, 39 Cal. Rptr. 184 (1964).

4. See cases cited in The Traub Co. v. Coffee Break Serv., Inc., 66 Cal.2d at 371, 57 Cal. Rptr. at 848, 425 P.2d at 792.

Published by GGU Law Digital Commons, 1967

A similar sensitivity to the harshness of a forfeiture of substantive rights was apparent in the opinion in *Old Fashion Farms v. Hamrick.*[5] Plaintiff, Old Fashion Farms, brought an action for declaratory relief and specific performance of an oral agreement to enter into a written lease and option to purchase real property. Plaintiff had come under the suspension of Revenue and Taxation Code section 23301 after the pleadings, but prior to commencement of the trial. When the defendant raised the issue of incapacity, plaintiff moved for a thirty-day continuance to seek reinstatement. The court denied the motion and was upheld by the court of appeal. One could argue that a suspended corporation has no existence and hence even entertainment of a motion for a continuance is improper. The court held, however, that hearing such a motion and granting a continuance were in the sound discretion of the trial court, which discretion should be exercised in the light of the substantive issues at stake in the proceedings. The court upheld the denial of the motion for a continuance, but only after stating that "our independent examination of the contract . . . shows . . . that it could not be specifically enforced in any event,"[6] and that plaintiff had failed to make any effort to revive its good standing in the four months prior to the making of its motion.

Relationships Affected by the Corporate Entity

Transactions between a corporation and its directors are closely scrutinized by the courts and are subject to the general rule that the burden of proving the reasonableness or fairness of such transactions is on the fiduciary.[7] On the other hand, transactions between a director or officer and a third party are presumed not only to be within the scope of authority,

5. 253 Cal. App.2d 273, 61 Cal. Rptr. 254 (1967).

6. Given the demonstrated desire of the California courts to resolve substantive rights on substantive grounds, it would be interesting to speculate on whether the harsher rule now apparently applicable to foreign corporations will endure. See Cal. Rev. & Tax. Code § 23301; Alhambra-Shumway Mines, Inc. v. Alhambra Gold Mine Corp., 155 Cal. App.2d at 50–51, 317 P.2d at 652 (1957).

7. See, e.g., Tevis v. Beigel, 156 Cal. App.2d at 15, 319 P.2d at 102–103 (1957); Remillard Brick Co. v. Remillard-Dandini, 109 Cal. App.2d at 420, 241 P.2d 66, 75 (1952).

but also to be in good faith. Therefore, the burden of proof is on the party challenging such transactions.[8] The court of appeal, in *Thompson v. Price*,[9] seems to have blurred this distinction. In that case, plaintiff, in part, sought to recover salaries and fees paid out by the corporation to defendant directors A and B, and a secretary. Neither the secretary nor B performed services of value for the corporation. The trial court found that plaintiffs had not proved the unfairness and unreasonableness of the salaries and fees sought to be recovered, except for a small portion. The court of appeal, in holding that the burden of proof had been improperly placed, stated that since A was a director, an officer (general manager) and the attorney for the corporation, he owed a fiduciary duty that required him to prove the drawings he "manipulated" were fair and reasonable, including the dispersal of funds to the secretary.

It is clear that the court was correct in concluding that since A and B were directors contracting with the corporation, under the general rule they must assume the burden of proving the reasonableness of the salaries paid to themselves by the corporation. But the salary paid to A's secretary presents a different situation. Here, from the facts given in the case, the secretary appeared to be a third party with whom the corporation contracted through defendant A. Although she was also employed by A in his individual capacity, no evidence of personal benefit for director A was introduced. Yet A was required to prove the fairness and reasonableness of the salary paid to the secretary. The application to this latter transaction of the general rule that requires a fiduciary in his dealings with the corporation to prove fairness and reasonableness appears to be an extension of that rule. Although the entire handling of the corporate affairs by defendant A appears to have been replete with fraud, the court's mere charac-

8. See Childress v. Dinkelspiel Co., Inc., 203 Cal. at 263, 263 P. at 802 (1928); Olson v. Basin Oil Co., 136 Cal. App.2d at 559, 288 P.2d at 962 (1955); Koshaba v. Koshaba, 56 Cal. App.2d at 313, 132 P.2d at 861 (1942); Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. at 557, 274 P. at 600 (1929); 3 Fletcher, CYCLOPEDIA CORPS., § 921 (1965).

9. 251 Cal. App.2d 182, 59 Cal. Rptr. 174 (1967).

terization of the particular drawing as one "manipulated" by defendant A, rather than made in the course of business, seems insufficient to shift the burden of proof. It is submitted that, absent proof of self-serving interests in the particular transaction, the rule requiring plaintiff to prove misdealing best adjusts the balance between the need for easy recourse against corporate fiduciaries and the continued need for flexibility and freedom of corporate fiduciaries to meet business demands.

The courts also made progress in further defining the scope of remedies available against corporate fiduciaries. Generally, a showing of actual injury and an award of compensatory damages is required in order to justify a recovery of punitive damages.[10] Authority exists, however, for the additional proposition that the requirements of the rule are met where it is shown that a tort entitling the plaintiff to compensatory damages was clearly proven, but no actual award of compensatory damages was made.[11] This latter rule was applied in the corporate area in *Topanga Corporation v. Gentile,*[12] where punitive damages against a promoter who had fraudulently acquired a substantial interest in plaintiff corporation were allowed. Defendant[13] and others were promoters of plaintiff corporation which had been formed for the purpose of purchasing a parcel of land. Each investor's contribution purchased a proportionate stock interest in the corporation and was to be used to pay for the property to be purchased. Defendant conducted the negotiations for the purchase of the property and indicated to the other promoters that the purchase price was $210,000. As part of the down payment to finance the purchase, defendant agreed

10. See Clark v. McClurg, 215 Cal. at 282–83, 4 P.2d at 150–151, 9 P.2d at 506, 81 A.L.R. at 910–911 (1931); Kluge v. O'Gara, 227 Cal. App.2d at 209, 38 Cal. Rptr. at 608 (1964); Haydel v. Morton, 8 Cal. App.2d at 736–37, 48 P.2d at 712 (1935); Chavez v. Times-Mirror Co., 72 Cal. App. at 697, 237 P. at 1086–87 (1925); Prosser, TORTS 13 (3d ed. 1964).

11. Finney v. Lockhart, 35 Cal.2d at 163–64, 217 P.2d at 21 (1950); Clark v. McClurg, 215 Cal. at 284–85, 4 P.2d at 151–152, 9 P.2d at 506–07, 81 A.L.R. at 911–912 (1931); Sterling Drug, Inc. v. Benatar, 99 Cal. App.2d at 400–03, 221 P.2d at 970–71 (1950).

12. 249 Cal. App.2d 681, 58 Cal. Rptr. 713 (1967).

13. A husband and wife were codefendants in *Topanga* but they will be referred to in the singular.

to contribute a ranch, which he falsely represented as being worth $70,000, for a one-third interest in the corporation. The ranch was in fact worth only $10,000. The court of appeal affirmed the trial court's cancellation of the entire original issue of stock and order to reissue stock in proportion to the promoters' actual investment, but reversed its determination that no authority existed to grant punitive damages.

In holding that plaintiff was entitled to a determination of the issue of punitive damages on its merits, the court stated that "the fact that plaintiffs were not given a grant of monetary damages of a certain amount is not determinative."[14] The court concluded that plaintiff was indeed damaged by defendant's fraud, since he had not received stock commensurate in value to his contribution to the corporation. The disregard of the strict rule, requiring an actual award of compensatory damages as a prerequisite to punitive damages, appears to make particularly good sense in *Topanga* because the relief awarded was clearly in effect an order requiring defendants to give up a property interest to plaintiffs that could have been translated into monetary terms.

The state legislature dealt with a director's duty of care by amending section 829,[15] which specifies those sources of financial information upon which a director may rely without fear of incurring subsequent liability for negligent violation of section 824. The latter section prohibits authorization by directors of certain transactions between a corporation and its shareholders except as provided for by statute. The amendment ratifies common business practices by making it clear that a director may rely on financial statements certified by *certified* public accountants, as well as those of public accountants.

The courts also resolved a previously unsettled issue in the relationship of shareholders *inter sese*. In almost all states, the notion that the proportionate share of capital investment of shareholders is the significant criterion for determining the

14. 249 Cal. App.2d at 691, 58 Cal. Rptr. at 719.

15. All statutory citations are to the California Corporations Code, unless otherwise indicated.

right of control through voting has replaced the notion of one man, one vote, that existed at early common law. However, the question of the precision with which proportional representation should equate with investment, that is, whether fractional voting should be permissible, rarely has been faced by the judiciary.[16] Some states provide expressly by statute for the right to vote fractional shares;[17] others, such as California, imply that fractional shares may be voted, by permitting disenfranchisement of fractional shares in the articles or bylaws of a corporation.[18] A widely cited Pennsylvania case,[19] on which much secondary authority is based, held that absent a legislative provision authorizing the voting of fractional shares, such voting is prohibited.

Garnier v. Garnier[20] decided the related but more unusual point whether an owner of a whole share may split that share into fractional votes.[1] Four of the nine shareholders of Garnier Enterprises, Inc. voted such a fractional vote in an election of directors, the result of which was a victory for their three candidates by one-third of a vote. The losers brought an action to determine the validity of the election and both the trial and appellate courts held that "only whole votes may be cast by persons holding only whole shares, absent some contrary provision in the articles or bylaws."[2]

Commentators have indicated that fractional shares per se present problems[3] and fractional voting assumedly would merely add to those problems. The argument in favor of fractional voting is that a stockholder's voting rights should be coextensive with his pecuniary interest in the corporation. Such an argument, however, does not carry over to split voting of whole shares. Even though such voting has oc-

16. See Ann. 98 A.L.R.2d 361 (1964).

17. See, e.g., Ore. Rev. Stat. § 57.126 (1953); Wis. Stat. Ann. § 180.19 (1957).

18. Cal. Corp. Code § 2215.

19. Commonwealth ex rel. Cartwright v. Cartwright, 350 Pa. 638, 40 A.2d 30, 155 A.L.R. 1088 (1944).

20. 248 Cal. App.2d 255, 56 Cal. Rptr. 247 (1967).

1. The *Cartwright* case also presented the issue whether the vote of a whole share may be split, but the court did not directly decide that issue.

2. 248 Cal. App.2d at 259, 56 Cal. Rptr. at 250.

3. See Sobieski, *Fractional Shares in Stock Dividends and Splits,* 16 Bus. Law 204, 205 (1960).

Business Associations

curred in California before,[4] it seems that no persuasive policy reason exists to warrant splitting whole votes and that *Garnier* therefore presents the proper resolution of the issue. Hence, in California today, voting of fractional shares is permissible unless the corporation expressly forbids it, and splitting of whole votes is not permissible unless the corporation expressly allows it.

Voting, though, is only one method of ownership control of corporate transactions. A more direct method is that of a suit brought by a shareholder against a party who has wronged the corporation. Section 834 sets forth required conditions precedent before an individual may bring such a derivative action on behalf of a corporation or an unincorporated association. The section's function is to provide some measure of protection from strike suits,[5] which are derivative actions brought to achieve some covert personal gain for the litigator. One feature of the section has been to grant some measure of protection from the adverse effects of spurious litigation by allowing the corporation or a defendant director or officer to move that the court require the plaintiff to furnish security in an amount fixed by the court to cover "reasonable expenses, including attorney's fees, which may be incurred by the moving party and the corporation in connection with such action, including expenses for which said corporation may become liable pursuant to Section 830."[6] If the court determines that security should be furnished, the action is dismissed unless it is furnished within a reasonable time.

Without the security provision, corporations might be coerced by such suits into paying a settlement to a plaintiff by

4. See Dulin v. Pacific Wood & Coal Co., 103 Cal. 357, 35 P. 1045, 37 P. 207 (1894); Edward Sidebotham & Son, Inc. v Chandler, 183 Cal. App.2d 823, 7 Cal. Rptr. 216 (1960).

5. See Beyerbach v. Juno Oil Co., 42 Cal. 2d at 23, 265 P.2d at 8 (1954); Ballantine, *Abuse of Shareholders Private Suits: How Far is California's New "Security for Expenses" Act Sound Regulation,* 37 Calif. L. Rev. 399 (1949); *Comment,* 1 U.C.L.A. L. Rev. 79, 80–81 (1953).

6. Cal. Corp. Code § 830 allows corporations to indemnify directors, officers, or employees for expenses incurred in the defense of suits arising out of a position in, or activities undertaken on behalf of, the corporation under specified conditions.

virtue of a suit's mere existence rather than its merits,[7] since the alternative might be lengthy and costly litigation. On the other hand, the security requirement could be an offensive weapon in the hands of a wrongdoing corporation, officer or director. Where a plaintiff has meager economic resources behind a meritorious, good-faith attempt to correct an abuse of corporate power, the security requirement might provide a technique for nipping in the bud any controversy over improper corporate activities.[8] The technique of making a motion for security might also provide a costly delaying tactic that could have the collateral effect of forcing a legitimate suitor out of the courts, even if the motion proves unsuccessful.

The legislature has now amended section 834 to provide a maximum for the security amount that can be fixed by the court. The order fixing the nature and initial amount of the security may not exceed $25,000, and the total amount resulting from discretionary increases allowed by the statute as the action progresses may never exceed $25,000.

The amendment also provides a technique whereby the plaintiff can eliminate the hearing on a motion for security, with its attendant delay and cost. In response to an allegation by a moving party that the situation is such that security should be required by the court, the plaintiff may choose to post a bond in the maximum amount prior to the holding of the hearing on the motion, and thereby obviate the necessity for such a hearing. Unless the plaintiff chooses to post a bond in the maximum amount of security, the nature of the security is at the discretion of the court, and other assets of the plaintiff may be accepted.[9]

Even given these plaintiff-oriented amendments, however, it is unlikely that persons who bring spurious litigation, but lack some independent wealth, are apt to receive succor from the limit on security. Once a court has found that "there is no reasonable possibility that the . . . action . . .

7. See Cohen v. Beneficial Loan, 337 U.S. 541, 548, 93 L.ed. 1528, 1537, 69 S.Ct. 1221, 1226 (1949); *Comment,* 3 Stan. L. Rev. 151, 153–54 (1950).

8. See Hornstein, *New Aspects of Stockholders' Derivative Suits,* 47 Col. L. Rev. 1, 2–7, 31–32 (1947).

9. Cal. Corp. Code § 834(b)(2); Beyerbach v. Juno Oil Co., 42 Cal.2d at 26–27, 265 P.2d at 10–11 (1954).

will benefit the corporation or its security holders,"[10] it is unlikely that the plaintiff would be able to find a surety willing to advance the necessary funds.

Those persons initiating derivative suits did not similarly benefit from judicial change during 1967 in the law of section 834. If a security amount was repressive,[11] plaintiffs in the past had sought and received appellate review of the security order.[12] In a carefully reasoned decision in *Woodman v. Ackerman,*[13] the first district (Ellington, J.) held that such an order is not appealable. The court reasoned that either the order setting security or the judgment of dismissal, if the security is not posted, is appealable, but not both. Since the trial court may alter its order setting security prior to the judgment of dismissal, and since the judgment of dismissal is without prejudice, the court held that hearing the issue only in the form of an appeal from the judgment of dismissal would best further the interests of justice. The decision has particular validity now that a maximum security amount has been legislatively imposed on the security. Although it results in a restraint from interposition of appellate review until the trial court has made its final determination in the matter, the likelihood of imposition of a repressive security is now reduced and the derivative suitor is subject to no worse penalty than a delay in the final resolution of his allegations.

One other change in shareholder power that should be noted is that the requirements for shareholder approval of agreements for merger or consolidation of corporations have been altered by amendments to sections 2239, 4107, 4110 and 4111 of the Corporations Code, which accord with recommendations made by the State Bar Committee on Corpo-

10. Cal. Corp. Code § 834(b)(1).

11. The amount set in Woodman v. Ackerman, 249 Cal. App.2d 644, 57 Cal. Rptr. 687 (1967), for instance, was $245,000 or almost ten times the amount allowable under amended § 834. If this sum represents an accurate estimate of costs, one may argue that the legislative ceiling gives little real security to defendants and operates only to discourage the faint-hearted strike suitor.

12. See Marble v. Latchford Glass Co., 205 Cal. App.2d 171, 22 Cal. Rptr. 789 (1962).

13. 249 Cal. App.2d 644, 57 Cal. Rptr. 687 (1967).

Published by GGU Law Digital Commons, 1967

rations.[14] The effect of the amendments to the four sections is to allow shareholders to approve mergers or consolidations without a formal meeting. Written consent must be unanimous, however, rather than merely by two-thirds approval.

Corporate Securities: Legislation and Case Development

Several important amendments to the Corporations Code revised the law affecting securities regulation. The most significant change was the addition of a provision that allows curative permits to be issued by the corporations commissioner to alleviate the consequences of an improper security issuance.[15] Under prior law, in cases where no permit had been issued prior to the sale of a security or where a security had been sold in non-conformity with a provision of a permit that had been issued, Corporations Code section 26100 had rendered the security void. The courts had already mitigated the most extreme consequences of the literal statutory language of section 26100 by refusing to allow a party who was the issuer or in *pari delicto* with the issuer to have the issue declared void.[16] Therefore, a security issued without a permit has been viewed as voidable, at the discretion of an innocent shareholder.[17]

This judicial development left unresolved problems, however. Unlike many jurisdictions, California's securities law

14. Comm'r of Corp., Report of the Comm'r, 41 Cal. St. B.J. 795 (1966).

15. Cal. Corp. Code § 25518.

16. See Domestic & Foreign Petroleum Co., Ltd. v. Long, 4 Cal.2d at 558–61, 51 P.2d at 77–79 (1935); Western Oil & Ref. Co. v. Venago Oil Corp., 218 Cal. at 743–45, 24 P.2d at 975–76, 88 A.L.R. at 1278–80 (1933); Eberhard v. Pacific Southwest Loan & Mortgage Corp., 215 Cal. 226, 9 P.2d 302 (1932); Maner v. Mydland, 250 Cal. App.2d at 529, 58 Cal. Rptr. at 742–44 (1967).

17. See Haakh, *The Amorphous Concept "Void" of Corporations Code Section 26100,* 29 L.A.B. Bull. 292, 293 (1954); *Note, Noncomplying Securities in California: Judicial Protection of Interests under Corporations Code § 26100,* 18 Stan. L. Rev. 1184 (1966). The innocent shareholder may not always be protected, however; see Reed v. Norman, 41 Cal.2d 17, 256 P.2d 930 (1953). The legislature itself experimented with a "voidable" rule in the 1930's, which rule included a provision for a curative permit. The rule was short-lived, however, being in effect only from 1931 to 1933. See Dahlquist, *Regulation and Civil Liability under the California Corporate Securities Act: III,* 34 Cal. L. Rev. 543, 545 (1946).

Business Associations

contains no express statute of limitations.[18] Unknowing and good-faith violations of the permit requirements presented grave problems of business uncertainty and operated, often unfairly, to give a purchaser an extended option on participation in the success of the business whose securities he had purchased.[19] Again, in those cases where only a technical violation of a permit had occurred, some effort had been made at mitigating these effects, this time through administrative practice. The practice involved the issuance of a new permit and a reissuance of stock in consideration of the claims against the issuer possessed by holders of the void securities.[20] Although the new permit had been described as a curative permit,[1] it was not retroactive[2] to the date of issuance. Nor was it possible to completely effectuate such a new issue without the voluntary permission of all of the security holders, some of whom might choose to be recalcitrant and play a waiting game with odds heavily stacked in their favor.[3]

Under the new statutory provision, an issuer may apply for relief to the division; if the commissioner finds that under the circumstances it would be "fair, just and equitable [to issue a curative permit] and that the applicant is transacting and intends to transact its business fairly and honestly," he may obviate the effect of section 26100 by issuing a curative permit.[4] Such a permit is effective retroactively as of the date the securities concerned were first issued and sold, thereby validating the original issue.[5] Further, when application for a curative permit has been made and a prima facie case

18. Dahlquist, 34 Cal. L. Rev. at 701–19.

19. Dahlquist, 34 Cal. L. Rev. at 708; *Note,* 18 Stan. L. Rev., at 1190. Consider, for instance, the potential for unfairness presented by the arguable ability of franchise holders to avoid their obligations under the Commissioner's decision (discussed *infra*) to treat many franchise agreements as securities.

20. Corporation Commissioner, *Curative Permits,* 43 Cal. St. B.J. 103, 104 (1968).

1. See Wheat, *Issuance of Securities under the California Securities Law,* in C.E.B., ADVISING CALIFORNIA BUSINESS ENTERPRISES 497, 552–553 (1958).

2. Non-retroactivity might leave some problems unsolved; such as, for instance, the questionable effectiveness of corporate acts requiring shareholder approval taken prior to the new issue. See *Note,* 18 Stan. L. Rev. at 1190.

3. See Wheat, C.E.B. 497, 552–553.

4. Cal. Corp. Code § 25518.

5. Cal. Corp. Code § 25519.

Published by GGU Law Digital Commons, 1967

for granting a curative permit has been shown, the applicant has the right to have stayed any trial "which turns on the provisions of section 26100" until the commissioner makes a decision on the application.[6] This provision would therefore allow an issuer surprised by an allegation that his securities were void to rectify the matter even at the last minute.

Curative permits are apt to provide needed protection for all parties in transactions where securities law violations have taken place, despite good-faith attempts to comply with the law. Persons having interests in the enterprise, but no relationship with the guilty party, will not be inadvertently penalized, and yet the amendments will allow action to be taken against parties who have engaged in faulty conduct. This result will obtain because the issuance of a curative permit renders inapplicable only the voiding provisions of section 26100; the curative permit "shall have no effect on the criminal liability of any person nor upon any cause of action other than that based on the provisions of Section 26100."[7]

The legislature also added language to section 25100, which sets forth securities that are exempt from the provisions of the Corporate Securities Law. Subsection (a) of section 25100, which sets forth exemptions for securities issued by governmental agencies, was amended by adding to the categories of governmental agencies exempted any "public district or authority, or other public agency, public entity, or public corporation therein."[8]

Subsection (k) of section 25100, which exempts securities issued under the Federal Bankruptcy Act, was also amended by adding the words "or plan of arrangement" to the provision for exemption of securities "issued under or pursuant to

6. Cal. Corp. Code § 25521.

7. Cal. Corp. Code § 25520.

8. This exemption does not ordinarily apply to transactions of brokers (§ 25101). Because § 25602 requires the submission to the commissioner of "advertisements" (see § 25600) for the sale of securities for possible disapproval (§§ 25602, 25603), brokers would be required to submit advertising related to otherwise exempt public body securities absent a specific exemption in § 25602. In order to retain a congruity between exemptions affecting public agency securities, securities which are free themselves from regulation by the commissioner of corporations, § 25602 was also amended to render its exemption provision for such securities identical with that of § 25100(a).

Brandel: Business Associations

a plan of reorganization. . . ." The legislature declared, however, that neither the amendment to subsection 25100(a) or subsection 25100(k) should be construed as making any substantive change in the existing law.[9]

An addition to the exemption provisions that did work a change in the existing law is contained in paragraph 2 of new subsection (o) of section 25100. That subsection deals with life income contracts issued by "a company organized . . . exclusively for educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit . . ." to persons who donate property to the organization. The contract is essentially an annuity for either the donor or a person designated by the donor. Paragraph 1 of subsection (o) specifically exempts all such contracts that were issued prior to the amendment. Here again, the legislature stated that this exemption provision was only declarative of existing law.[10]

Future contracts in this category will not automatically be exempt from the provisions of the Corporate Securities Law, however. An organization desiring to issue such contracts without a permit must now seek an exemption for the organization by order of the commissioner. He is empowered to allow such an exemption for the particular issuer rather than the particular security, if he finds

> that such company is of such size or has such investment experience or capability that the protection of the public otherwise provided by the issuance of a permit is not required, and that the exemption of such agree-

9. Cal. Stats., ch. 1411, § 3 (1967). Whether the additional language of § 25100(a) in fact only reflects the previous law is not a question beyond dispute. Although no judicial opinion was located that held otherwise, the Attorney General suggested in an opinion on Sept. 8, 1966 (before recalling it on Oct. 7, 1966) that the exemption did not apply to "securities of state authorities, agencies, districts, or similar bodies without taxing powers. . . ." 48 Op. Att'y Gen. 90, 92 (1966). This opinion, which reached the same result as to the scope of the exemptions of § 25602, was in large part based on the specific statutory enumeration of exempt bodies followed by a general exemption for a "taxing district." The amendments to both § 25100(a) and § 25602 deleted the phrase "taxing district."

10. Cal. Stats. ch. 1411, § 3 (1967).

ments, contracts or other arrangements offered or issued by such company is in the public interest.[11]

Some degree of control is now exercised over such arrangements, therefore, where previously none existed.

The legislature took a rather firm position with respect to another type of organization that may well be both educational and nonprofit in nature, a company organized for the "promotion, development or operation of a world's fair."[12] New section 25102.5 of the Corporations Code not only removes a general exemption for securities of such an issuer, it eliminates the availability of statutory provisions of general application that would ordinarily exempt the types of securities enumerated from the provisions of the Corporate Securities Law. A world's fair company is now denied exemptions available to other issuers for certain securities of nonprofit organizations, which include commercial paper issued in the ordinary course of legitimate business, and promissory notes that are issued in a private offering.[13]

The Court of Appeal for the Second District judicially defined the scope of section 25100(1) during the past year. That section exempts from the provisions of the Corporate Securities Law "any partnership interest in a general partnership, or in a limited partnership where certificates are executed, filed, and recorded as provided by sections 15502 and 15525 . . . , except partnership interests when offered to the public."

In *Solomont v. Polk Development Co.*,[14] plaintiffs sought, among other things, rescission of a partnership agreement allegedly based on fraud and, based on the void security provisions of section 26100, recovery of amounts paid by

11. Cal. Corp. Code § 25100(o)(2). The fee for obtaining an order for such an exempt status is $50.00 (Cal. Corp. Code § 26018).

12. See U.S. NEWS & WORLD REPORT, Jan. 3, 1966, at 8. If experience is any teacher, one may profit vicariously from the New York World's Fair venture and conclude that some of such organizations not only are nonprofit, but that they present a considerable investment risk for those who purchase their securities.

13. See Cal. Corp. Code §§ 25102(a), (b) and (c).

14. 245 Cal. App.2d 488, 54 Cal. Rptr. 22 (1966).

Brandel: Business Associations

them into the partnership. The partnership at issue had been formed by defendant company and other individuals who had been solicited by an agent of defendant. The purpose of the partnership was to construct and operate a fifty-unit apartment building. Partnership interests were sold to plaintiffs in a transaction wherein misrepresentations were made as to the total cost of the building. After completion of the building and its operation for three years, the partnership became insolvent and plaintiffs brought the action to recover their investment. The judgment, as affirmed by the court of appeal, allowed plaintiffs to recover the amount of their contributions less receipts from operation of the apartment building that had been turned over to them. The opinion contains several threads of analysis, only some of which bear on whether a permit to issue the partnership interests should have been obtained.

The court's holding that a permit was necessary was based on three factors. First, the court held that failure of defendant to comply with the specific provisions of section 15502, which sets forth the filing requirements for a certificate of limited partnership, foreclosed the business transaction from being a valid partnership. Next, the court held that the misrepresentation in the formation of the partnership rendered it one induced by fraud and it was, therefore, void *ab initio*. Finally, citing *Rivlin v. Levine*,[15] the court held that the business formed could not have been a partnership within the meaning of section 25100(1) because the partners were individually solicited and therefore "did not have the right of mutual selection of all their copartners."[16]

The court reached the correct result in the case, but it seems that some of its language in discussing the above three factors may create an unnecessary ambiguity in partnership law and the scope of the securities law exemption for partnership interests. With regard to whether a party is deprived of the exemption of 25100(1) because of a failure to fully comply with the provisions of sections 15502 and 15525, it

15. 195 Cal. App.2d 13, 15 Cal. Rptr. 587 (1961).

16. 245 Cal. App.2d at 492, 54 Cal. Rptr. at 25.

Published by GGU Law Digital Commons, 1967

is submitted that the preferable analysis is contained in *Farnsworth v. Nevada-Cal Management, Ltd.*[17] That case examined the purposes of the Corporate Securities Law exemption for partnerships and stated "that any abortive attempt to form such an organization [limited partnership] results in a general partnership and . . . [t]hus all types of partnerships are exempt from application of the Corporate Securities Law provided the interests therein are not offered to the public."[18] The court in *Solomont* based its conclusion on the disparate purposes of the statutes involved. Both the securities law and the limited partnership law operate to protect the public, but the purpose of the former is to protect the public from insubstantial investment schemes. So far as part of its purpose is public protection, the Limited Partnership Act protects the public dealing with partnerships from an unpublicized assertion of limited liability by members of the partnership[19] and is effective without invoking the securities law. The court did not discuss the *Farnsworth* analysis. Insofar as the implication of *Solomont* is that failure to comply with the filing provisions under the act results in retroactive automatic activation of legal rules designed to regulate transactions among investors *inter sese,* the court's analysis appears to be potentially troublesome.

The second concept, that a fraud in the formation of the partnership renders the partnership void *ab initio* for purposes of the securities law, has little support in California law. The unreported case, *Miller v. Kraus,*[20] cited as an authority in *Solomont,* did not involve a securities law question. It announced and expanded upon a theory of voidness *ab initio,* but the order of the California Supreme Court denying a rehearing[20a] cast considerable doubt on the validity of the anal-

17. 188 Cal. App.2d 382, 10 Cal. Rptr. 531 (1961).

18. 188 Cal. App.2d at 386, 10 Cal. Rptr. at 533. The language in *Farnsworth* was over broad in labelling the resulting business form a general partnership for all purposes, for aside from the soundness of the *Farnsworth* analysis *vis-à-vis* the securities law, the general rule under the Uniform Limited Partnership Act is to the contrary. See United States v. Coson, 286 F.2d at 461–62, n. 13 (9th Cir. [1961]).

19. See 2 Rowley, PARTNERSHIP 562 (2d ed. 1960).

20. 155 P. 834 (Cal. App. 1915).

20a. Miller v. Krause, 155 P. 838 (1916).

Business Associations

ysis. A general rule of voidability of the partnership by the particular person defrauded is well recognized, but it controls only the rights between the immediate parties. The rule, for instance, does not affect a defrauded partner's rights vis-à-vis liability to third parties, nor does it affect the rights of partners who were not defrauded *inter sese*.[1] The remedy for the defrauded partner is rescission and restitution under either the concept of recovery based on a theory of failure to obtain the necessary permits, a violation of the Corporate Securities Law that brings into play section 26100, or under the concept of a recovery based on a fraudulent creation of the partnership. It would seem unnecessary, therefore, to speak of the entire partnership entity as void and to invoke the Corporate Securities Law in order to reach the proper result.

Admittedly such a rule produces a poetic justice of sorts. The securities law is designed to protect the public from fraud in those transactions it covers and the court's rule would automatically bring some typically exempt transactions within the scope of the law if fraud were involved. But there is an "overkill" potential in reaching the result through section 26100, in the possible exposure of persons to criminal sanctions where none were intended.[2] Further, the effect of such a rule on other members of the voided partnership, who may have engaged in no fraud in the transaction, is not clear.

The third line of analysis, that of the mutual selection requirement, was considered separately from the two preceding analyses.[3] The holding that an essential element of a true limited partnership is the mutual selection of all members of the limited partnership is based on a California case, the holding of which was primarily based on a leading article

1. See Crane, PARTNERSHIP, § 85 (1952); 1 Rowley, PARTNERSHIP, 751–53 (2d ed. 1960).

2. See Cal. Corp. Code §§ 26103, 26104. Unlike the proposed Corporate Securities Law (Assembly Bill 1, 1968 Reg. Sess. Calif. Legis. [1968]), under which the civil and criminal liability provisions are applicable even to exempt securities, the current securities law provides exemptions from all its provisions.

3. "Wholly apart from the mutual selection test of *Rivlin*, . . . the entity was not an exemption within the meaning of section 25100. . . ." 245 Cal. App.2d at 495, 54 Cal. Rptr. at 26.

dealing with corporate securities.[4] As the author of that article points out, however, the governing statute indicates that a right of mutual selection is not a *sine qua non* of a valid limited partnership, for the business relationship may be constructed so as to limit that right and, instead, to allow substitution of limited partners without the consent of other partners.[5] It has been noted that a limited partner has little interest in the selection of other partners because of his relative lack of participation in management or control.[6] The reason for the mutual selection rule, therefore, thus does not seem to dispose persuasively of the existence or nonexistence of a limited partnership.[7]

It cannot be denied that the right of mutual selection is a force persuasive of the lack of need for regulation under the securities law,[8] but it does not seem that exercise of that right

4. Dahlquist, *Regulation and Civil Liability under the California Corporate Securities Act,* 33 Cal. L. Rev. 343, 363 (1945).

5. See Cal. Corp. Code §§ 15018, 15502(a)X, XI, 15519(4). Absent an agreement to the contrary, permitted by these statutory provisions, the rule is clear that "no person can become a member of a partnership without the consent of all the partners." Cal. Corp. Code § 15018(g).

In deciding whether a partnership interest was within the scope of the Illinois and federal security laws, an Illinois court recently said:

"The general rule that new members of a partnership . . . must be known to and approved by the existing members of the group is subject to the agreement on which the relationship is based. [citation] In the instant case, it was clear from the communications between [the initiator and an investing partner] that the members of the group were not specifically identified for the plaintiff and the size of the group was not fixed at the time the plaintiff joined. We take it that the plaintiff joined with this knowledge, which in effect became a part of the informal agreement on which the venture was based." Polikoff v. Levy, 55 Ill. App.2d at 336, 204 N.E.2d at 810 (1965).

Dahlquist, *supra* n. 4 cited the requirements for the signatures of all members on amendments to the partnership certificate (Cal. Corp. Code § 15525), apparently to substantiate his discussion of the requirement for unanimous approval, but such approval was not necessary then, as he pointed out. Not even the signatures are required now in some cases (Cal. Corp. Code § 15525.5), even in those situations where approval of all partners is necessary.

6. See 2 Rowley, PARTNERSHIP 549 (2d ed. 1960); Crane, PARTNERSHIP 34 (2d ed. 1952).

7. Compare the rules responsive to the actual business relationship between "partners" developed for the special business form called a "mining partnership." Skillman v. Lachman, 23 Cal. at 206, (1863); Pub. Res. Code, §§ 2351–2361.

8. See Dahlquist, 33 Cal. L. Rev. at 361–67.

Brandel: Business Associations

should be essential to the existence of a valid limited partnership. Such a criterion might better be applied as a factor in determining whether the offering of the limited partnership interests was private or public.[9]

The Attorney General issued an unpublished opinion during 1967 interpreting the scope of another exemption of the Corporate Securities Law, that covering "a beneficial interest issued by a retirement system. . . ."[10] The opinion analyzes whether a stock bonus plan as part of a retirement system is permissible when it contains certain withdrawal provisions. The provisions under consideration allowed withdrawal of both the employee and employer contributions on termination of employment, but only as much of the latter as had "vested"; withdrawal at any time of the employee contribution only, with suspension from participation for one year as a consequence; and withdrawal of either the employee or employer contribution in time of personal need, as determined by an administrative committee, with no penalty.

The Attorney General had previously held that other plans containing withdrawal provisions did not qualify for the exemption. The plan here under scrutiny by the Attorney General, unlike previous plans submitted to the Attorney General for opinion, contained more stringent deterrents to withdrawal. The employee, for instance, could ordinarily withdraw all of his stock only by quitting his job; withdrawal of portions of his contributions would cause him to be suspended from participation in the plan for a year; and a third permissible type of withdrawal could occur only under limited circumstances. The Attorney General stated, therefore, that such contributions of stock to a retirement system, where the primary purpose was to provide benefits on retirement, was permissible and within the scope of the exemption. Although the withdrawal privileges provided collateral benefits, the lim-

9. In this regard see the discussion of factors used by the Commissioner in such an evaluation, *infra*, particularly those of (1) "the relationship of the offerees to each other," and (2) "the relationship between the issuer and the offerees."

10. Cal. Corp. Code § 28006; 49 Op. Att'y Gen. 144 (June 28, 1967).

Published by GGU Law Digital Commons, 1967

itations on those privileges rendered them consistent with the primary purpose.

Lastly, the legislature provided additional protection to the security-buying public by tightening the requirements for brokers. California's Corporate Securities Law has long had a provision for bonding as a prerequisite for favorable action on an application for a brokerage certificate. A surety may cancel the broker's bond, however, provided that he gives thirty days' written notice to the commissioner. In order to protect the public from a broker who might have a broker's certificate and yet may no longer have a bond, language has been added to section 25703 that makes failure to file a replacement bond prior to termination of the old bond sufficient reason for suspension or revocation of the broker's certificate. It further provides that in those cases where a new bond has not been filed prior to the issuance of the notice of a hearing for suspension or revocation of the certificate, such hearing may be in an abbreviated form.[11]

Corporate Securities: Commissioner Action

Perhaps as important as formal statutory amendments are the regulations and other guidelines, in the form of bulletins, that are issued by the commissioner of corporations in accordance with the authority vested in him by Corporations Code section 25308. Several of the changes made administratively in the past year affected areas long recognized as needing change. The rules are steps in the direction of goals currently sought through legislative amendment of the securities law, and may well be precursors of such legislative change.

The most significant change was the introduction of a new "legend condition" to be used when permits are applied for by corporations seeking to engage in an initial and private

11. Although the hearing need not comply with the full provisions of the Administrative Procedure Act under these circumstances, its procedure is nevertheless subject to minimum principles of due process. Abrams v Daugherty, 60 Cal. App. at 299–304, 212 P. at 943–45 (1922); see Endler v. Schutzbank, 68 Cal.2d —, 65 Cal. Rptr. 297, 436 P.2d 297 (1968); Drummey v. State Bd. of Funeral Dirs., 13 Cal.2d at 80, 87 P.2d at 851 (1939); Suckow v. Alderson, 182 Cal. at 250, 187 P. at 966 (1920); Angelopulos v. Bottorff, 76 Cal. App. at 625–28, 245 P. at 448–50 (1926).

offering of their securities.[12] The new technique substitutes a legend condition where the commissioner would previously have imposed an escrow condition.[13] The legend condition requires imprinting on the security a legend prohibiting transfer of the security, without the consent of the commissioner,[14] except to specified transferees. The commissioner stated, "The legend condition, by eliminating the requirement of an escrow holder, will eliminate the expense to companies, attorneys and the Commissioner incident to the maintenance of an escrow holder . . . [and] in most cases would serve equally to protect the public against secondary transfers."[15] The commissioner encourages applicants to use shortened form applications, devised by the commissioner, for a permit with a legend condition if the proper criteria are met. To meet the criteria the applicant must be a California corporation which has no securities outstanding, and which does not

12. The original versions of the provisions applicable to the new legend condition were promulgated by Commissioner of Corporations Bulletins Nos. 67–3, 67–4 and 67–7. After minor revisions, they were promulgated in final form, to be effective November 22, 1967, as Title 10, California Administrative Code, sections 320.6, 407.2, 407.3 and 419. These implementing regulations are expected to have a broad impact, since it is estimated that they will affect between ten and eleven thousand applications annually, or as much as 60 percent of the original issue applications handled by the commissioner.

13. A proposed amendment to the Corporations Code will exempt security issues of the type covered by these rules from the necessity of seeking any permit, provided that a prescribed legend is imprinted on the face of the security. Assembly Bill 1, 1968 Reg. Sess. Calif. Legis. § 25102(h) (1968).

14. The legend currently prescribed reads as follows: "IT IS UNLAWFUL TO CONSUMMATE A SALE OR TRANSFER OF THIS SECURITY, OR ANY INTEREST THEREIN, OR TO RECEIVE ANY CONSIDERATION THEREFOR, WITHOUT THE PRIOR WRITTEN CONSENT OF THE COMMISSIONER OF CORPORATIONS OF THE STATE OF CALIFORNIA, NAMING BOTH TRANSFEROR AND TRANSFEREE, EXCEPT THAT TRANSFERS MAY BE EFFECTED WITHOUT SUCH CONSENT TO THE TRANSFEROR'S PARENTS, CHILDREN, GRANDCHILDREN, SPOUSE, AND CUSTODIANS OR TRUSTEES FOR THEIR ACCOUNT, OR TO HOLDERS OF SECURITIES OF THE SAME CLASS OF THE ISSUER OF THIS SECURITY, ON CONDITION THAT ANY CERTIFICATE EVIDENCING THIS SECURITY ISSUED TO SUCH TRANSFEREE SHALL CONTAIN THIS LEGEND CONDITION."

Because the content of the legend changed twice in the seven months between its initial and latest promulgation, counsel must insure that the legend imprinted on any given security is the precise legend authorized by the permit. If use of the current legend is desired in cases where the permit authorizes an older form, an amendment to the permit must be obtained.

15. Commissioner of Corporations Bull. 67–3, at 1.

propose to use any prospectus or advertisement or to pay any commission or compensation for the sale of its securities. It must also be one "whose securities are to be sold to not more than five issuees,[16] each of whom is either an officer or director of the issuer, or related to an officer or director as a parent, child, grandchild, spouse, and custodian or trustee for their account."[17] While the language of the rule seems applicable to natural persons only, the rule is also meant to apply in cases where the issuee is a corporation.[18] The substitution of the legend condition will be of economic advantage whether or not transfers take place, but it should be noted that the normal legend condition allows transfers to be effected without the consent of the commissioner when the transfer is made to "the transferor's parents, children, grandchildren, spouse, and custodians or trustees for their account, or to holders of securities of the same class of the issuer of this security. . . ."[19] This provision obviates the necessity for applying for a consent to transfer securities subject to the legend condition in the instances enumerated,[20] and of course

16. The legend condition was originally available only where there was to be but one issuee (Commissioner of Corporations Bull. No. 67–7), but its availability was later expanded to application contemplating the present maximum of five issuees. The increase in scope of this simplified condition procedure may be ascribed to the commissioner's general effort to reduce the burdens on businessmen and the division of corporations in areas where stringent regulation was felt to be relatively unnecessary. A collateral benefit, of course, is the freeing of the division's resources so it might concentrate its regulatory efforts in areas where the potential for fraud and abuse are the greatest. See generally Volk, *Fifty Years of Securities Regulation in California,* 42 L.A.B. Bull. 569, 571–72 (1967).

17. 10 Cal. Admin. Code § 320.6.

18. See part I(b)(1) of the application at 10 Cal. Admin. Code § 320.6.

19. 10 Cal. Admin. Code § 407.3. The original legend condition contained no provision for transfer without consent (Commissioner of Corporations Bull. Nos. 67–3, 67–4). The permissive provision was likely added for the reasons set forth above in the discussion of the change in the number of issuees permissible. The addition of such terms to the legend condition is not without precedent in the practice of the division of corporations. A similar "special family escrow condition" was previously granted under certain circumstances, which condition allowed limited transfers of securities subject to an escrow condition without a formal order from the commissioner. 2 Ballantine & Sterling, CALIFORNIA CORP. LAWS, § 450.02 (1967).

20. The first resale of stock subject to a legend condition by a corporate issuee would, of course, require the consent of the commissioner in all instances, since that transfer could not be

eliminates the expense of preparation and the statutory fee associated with such an application.

The commissioner is giving the legend condition the broadest scope possible. It is applicable not only to new issues; it may also be substituted in a proper case for an escrow condition currently imposed upon outstanding securities by applying for an amendment to the original permit under section 26009.[1] Because the legend condition is expected to become the norm, the commissioner suggests that applicants who desire a formal escrow condition in lieu of the legend condition should so specify that fact in their applications.[2] It should be noted that the application form must contain the statement by any proposed issuee that "he has not been solicited to invest in applicant by any person," and must further contain an amplified statement of the issuee's relationship to the applicant. The proper forms for the application and the issuee's statement are set forth in title 10, section 320.6 of the California Administrative Code.[3] These statements will be accorded great weight by the commissioner in determining whether the transaction is "fair, just and equitable." Statements similar to those now required of proposed issuees have been required from proposed transferees in the past and have been utilized in reviewing applications by security holders for a consent to transfer a security subject to an escrow condition.[4] Where a consent to transfer is necessary, the requirements of section 419 have been extended to encompass applications for a consent to transfer securities subject to a legend condition.[5]

one authorized by the terms of the legend.

1. Commissioner of Corporations Bull. 67–3, at 1.

2. Commissioner of Corporations Bull. 67–3, at 2.

3. Unlike some S.E.C. forms, those associated with the legend condition are not simply exemplars. To further simplify the permit application process for both the division and the applicant, the forms found in the administrative code for the application for permit, statement of issuee, and statement of transferee may be obtained from the commissioner's office and may be completed merely by filling in the blanks. See Form, 43 Cal. St. B. J. 106 (1968).

4. 10 Cal. Admin. Code § 419.

5. Section 26005 of the Corporations Code, which stipulated the fee to be charged for an application for an order consenting to the transfer of securities held in escrow, was similarly amended by adding language so that it will impose the same fee for a consent to a

Although the decision whether to impose a legend or escrow condition is discretionary, the commissioner established guidelines by setting forth situations which, if existent, will result in the denial of a legend condition and an imposition of an escrow condition.[6] A legend condition will be denied by the commissioner if the shares are subject to waiver conditions applicable to promotional shares or if enumerated persons closely connected with the issuance of the securities have been convicted, within the preceding five years, of either a misdemeanor concerning a security, a theft, or any felony, or have been enjoined from engaging in activities in connection with the purchase or sale of securities. Two additional paragraphs to section 407.2 allow the commissioner to refuse to grant the legend condition in those situations where he deems it to be in the public interest to do so, either because he anticipates a statutory violation or for "other good cause."

The legislature added language to existing section 25509 to make administratively less burdensome the commissioner's duties with respect to securities still held by him in escrow. The legislature directed that in those cases where the commissioner acts as escrow holder for securities subject to an escrow condition, he may destroy the certificates in his possession if the corporation that issued the securities is suspended for a period of not less than two years for nonpayment of taxes or for other penalties. To protect the security holder, however, the commissioner is required to keep careful records of each certificate he destroys under the provisions of this amended section, and such records "constitute prima facie evidence as to the matters therein set forth."[7]

transfer of securities subject to any condition that requires the commissioner's consent to transfer. The section therefore now includes the legend condition within its scope.

6. 10 Cal. Admin. Code § 407.2.

7. An issuer must issue a replacement security on application by the owner under the provisions of Commercial Code § 8405, but typically the owner is required to post an indemnity bond. In order to provide relief from the onerous, and in this case unnecessary, burden such a bond imposes on the owner, it would seem feasible to interpret an indemnity requirement as unreasonable under circumstances where destruction of the certificate is verifiable. See Cal. Commercial Code § 8405(2)(c).

In another commissioner's bulletin,[8] entitled "Alternative procedure for filing of prospectuses or registration statements: conditional nondisapproval for use," the commissioner of corporations initiated a new procedure to assist proper state blueskying of issues registered with the Securities and Exchange Commission and thereby alleviated another administrative bottleneck. To understand the effect of the new procedure it would be well to discuss briefly the problem prevalent prior to the new procedure.

A registration statement filed with the Securities and Exchange Commission automatically becomes effective twenty days after filing unless the commission institutes a stop order proceeding.[9] The registration statements are typically devoid of certain price data when originally filed, which data are usually not included until the day of, or day prior to, the desired offering date, when a final agreement is reached between the issuer and the underwriters. At that time a "price amendment" is filed with the Securities and Exchange Commission which incorporates data concerning such items as the offering price and underwriting discounts or commissions and other selling expenses. The filing of an amendment ordinarily starts the twenty-day waiting period running anew. If all other factors are in order, however, the Securities and Exchange Commission typically accelerates the effective date of the registration statement, so that the offering can take place immediately.

Section 25602 of the Corporations Code requires that such an "advertisement" be filed with the office of the commissioner at least one day prior to use, and it may then be used absent notification of disapproval by the commissioner.[10] The prudent corporate lawyer would scarcely proceed with an offering, however, absent some communication indicating nondisapproval.[11] This requirement created communications problems in the final hours preceding a major security offering.

8. Commissioner of Corporations Bull. 67–6.

9. Fed. Sec. Act of 1933, 15 U.S.C. § 77h (1964).

10. Cal. Corp. Code § 25603.

11. See discussion of procedures for filing of advertising at 2 Ballantine & Sterling, CALIFORNIA CORPORATION LAWS, § 453 (1967).

Published by GGU Law Digital Commons, 1967

Cal Law Trends and Developments, Vol. 1967, Iss. 1 [1967], Art. 3

The commissioner should have sufficient information to be able to determine whether the offering would work a fraud on investors or would involve unreasonable profit for underwriters or sellers. Yet his need for a review of the specific financial terms of the underwriting is minimal. The commission has now alleviated the issuer's problem by offering to grant a conditional nondisapproval of a prospectus or registration statement, provided that certain information is furnished and conditions are met.[12]

The first condition is that the public offering price of the security must be committed to be between specified maximum and minimum amounts, and the price range may not exceed the applicable maximum range acceptable to the commissioner. Next, underwriting discounts or commissions must be committed to be not in excess of specified maximum amounts or percentages. Third, redemption prices or conversion prices must either be specifically set forth or else must be committed to be between specified maximum and minimum amounts. Further, if the dividend rate or amount of interest payable has not been definitely set forth, the rate or amount must be committed to be within ten percent of a specified maximum. Finally, if any other selling expense has not been definitely set forth, the application must state an amount that such expenses will not exceed.

If the conditional nondisapproval is granted, the issuer need only file a copy of the final prospectus or registration statement within two business days after the effective date to comply with section 25602.[13] The information contained in the commitments of the application is sufficient to enable the commissioner to determine whether the terms of the offering might be unfair and a subsequent prompt verification that the terms in fact complied with the commitment

12. This new procedure is intended to have no effect on the use of prepermit prospectus ("red herrings") by brokers. See title 10 Cal. Admin. Code, § 687. See generally 1 Loss, SECURITIES REGULATIONS, 187–93, 203–04 (2d ed. 1961).

13. The commissioner's nondisapproval, then, is conditioned upon only two factors. They are (1) the final effectiveness of the registration statement having terms within the commitments as set forth in the application, and (2) the subsequent filing within two business days of a copy of the final prospectus or registration.

is sufficient to protect the public interest.[14] In order that a corporation required to obtain a permit in California, in addition to approval of its advertising, is not placed in a disadvantageous position for a national issue, the same procedures may be used to obtain a permit, which would have the permissible underwriting terms stated in ranges, rather than fixed prices.[15] The form on which an application for such a conditional nondisapproval is to be submitted was promulgated as part of the bulletin.

The commissioner has also used his discretionary authority in another fashion to mitigate the administrative burden which Corporations Code section 25602 places both on licensed security brokers and on the division of corporations. Again he implemented a new rule that retains protection for the public in situations where it needs protection and yet allows a streamlined administrative procedure where other regulatory procedures and the internal business of reputable brokers will provide a sufficient protection. Hence, advertising need not be filed by a licensed security broker when it (1) does not contain false or misleading information; (2) is not communicated by means of public media; (3) does not concern a security subject to an escrow or legend condition; (4) concerns a security that is being offered by the broker as an agent only; (5) is approved by a responsible officer of the broker; and (6) is retained by the broker for a period of three years subject to the review of the commissioner.[16] An exemption for licensed security brokers from the conditions of section 25602 is further provided to eliminate the necessity for filing tombstone advertising,[17] or "such other advertising as is

14. See Loss and Cowett, BLUE SKY LAW at 123 (1958).

15. A similar provision allowing simultaneous effectiveness is found in the Uniform Securities Act, § 303(C). That provision deals with registrations and requires notification "by telephone or telegram of the date and time when the federal registration statement became effective and the content of the price amendment, . . ." in addition to a follow-up filing of the terms of the price amendment. Statutory provisions based on this section, which would allow a similar "qualification by coordination" when the S.E.C. registration statement became effective, have been proposed to the legislature. Assembly Bill 1, 1968 Reg. Sess. Cal. Legis. §§ 25111, 25300 (1968).

16. 10 Cal. Admin. Code § 641.

17. See 1 Loss, SECURITIES REGULATIONS, 226–32 (2d ed. 1961).

defined" by Securities and Exchange Commission rule 134,[18] which relates to securities for which a permit is already in effect or for which a nondisapproval prospectus is on file.[19] Such advertisements are only for the alleged purpose of "identifying the existence of a public offering and the availability of a prospectus and they are not to be selling literature of any kind."[20]

Such formal changes in commission practices are of much assistance to the practicing corporate bar, but also of considerable value are informal guidelines from the commissioner that aid corporate lawyers in interpreting the Corporate Securities Law and in being aware of commission attitudes. The corporate lawyer is often faced with a difficult decision, for instance, in trying to resolve whether a permit need be obtained for the issuance of a security when a question arises about whether his client's proposed offering is public or private.[1] To assist in this analysis, the commissioner of corporations has published a guideline for determining when securities are public in nature.[2] Although the commissioner cautioned that "the factors listed are not intended necessarily to be exclusive, and that the weight to be given to each of the factors will vary from case to case and that the final conclusion is thus determined not by an arithmetical procedure, but by value judgment," he did list, roughly rank, and discuss six factors he deemed significant in making such a determination.

The first two factors, "the number of offerees" and "the relationship of the offerees to each other," both essentially deal with the same factor, that is, the number of individual components in the group to which an offer is to be made. The second factor is related to the first, insofar as a close relationship between the offerees may indicate an exchange of information and appraisal among them so as to reduce effectively the number of individual investor units that are

18. 17 C.F.R. § 230.134.

19. 10 Cal. Admin. Code § 641(b).

20. Uniform Securities Act Rel. 3535 (1955).

1. Several provisions of the Corporate Securities Law provide exemptions for either particular issues or issuers if the security is not offered to the public. Cal. Corp. Code §§ 25100(l), (m); 25102 (c), (d).

2. Commissioner of Corporations Bull. 67-5.

involved as potential purchasers. The third factor is the character of "the relationship between the issuer and the offerees." Here, a finding of personal confidence of all, or most, of the offerees in the issuer would be a factor tending to indicate a private offering.

The fourth factor is the "size of the offering" and relates to whether the offering, measured both by the dollar amount of the individual security units and the number of units into which the issue is divided, is of a character that would be purchased by the general public. Where the individual security, for instance, is issued in one million dollar amounts, it is clearly foreclosed as an investment opportunity for the public, and it can be expected that only a relatively few offerees would be interested in such a security or would be solicited. Similarly, if a large enough number of units is involved so as to permit redistribution to the public, that factor may indicate a public offering even though no such initial distribution is contemplated.

The fifth factor, "the manner of the offering," was cited by the commissioner as "perhaps the most significant single factor" that is applicable to this determination. Significant here is whether the issuer or purchaser carries the investment initiative and how vigorously it is carried. The media used to convey the offer is also important, for it is indicative of the group intended to be reached. For example, an offering conducted by the use of radio, television, or mass mailings would most assuredly be categorized as public in nature.

The sixth and final factor deals with "the character of the security offered." As in the fourth factor, this factor primarily relates to the attractiveness of the security to the general investing public. Certain business enterprises, such as those in the electronics industry and certain real estate developments, attract widespread public interest, whereas securities containing unusual or uncommercial arrangements can be expected to attract only a relatively limited group of investors and only that group can be expected to be solicited. The commissioner further stated that he would issue an opin-

Cal Law Trends and Developments, Vol. 1967, Iss. 1 [1967], Art. 3

ion in those cases where he can clearly decide whether an offering is public in nature.[3]

The commissioner issued a second guideline pertaining to the applicability of the Corporate Securities Law to the franchise, a form of business gaining increasing currency. The guideline[4] is based on an opinion solicited from the Attorney General by the commissioner. The Attorney General's opinion[5] presented a new position on the question of whether franchise arrangements constitute securities within the meaning of the Corporate Securities Law.[6] The corporations commissioner requested the Attorney General's opinion on three variations that franchise arrangements might commonly take:

1. Where the franchisee participates only nominally in the franchised business in exchange for a share of the profits.
2. Where the franchisee participates actively in the franchised business and where the franchisor agrees to provide certain goods and services to the franchisee.
3. Where the franchisee participates actively in the franchised business and where the franchisor agrees to provide certain goods and services to the franchisee, but where the franchisor intends to secure a substantial portion of the initial capital that is needed to provide such goods and services from the fees paid by the franchisee or franchisees.[7]

As to the first situation, the Attorney General stated that the investor primarily purchased the right to share in proceeds

3. Such an opinion, and the bulletins themselves, are of a limited value (see Bank of Alameda County v. McColgan, 69 Cal. App.2d 464, 159 P.2d 31 [1945]), as compared to formal rules issued under the Administrative Procedures Act, which have the force of law. The proposed securities law would protect persons who rely on such communiques from liability from acts done in good-faith conformity therewith. Assembly Bill 1, 1968 Reg. Sess. Calif. Legis. § 25700 (1968). Compare *Fed. Sec. Act of 1934,* 15 U.S.C. § 78w.

4. Commissioner of Corporations Bull. 67–8.

5. 49 Op. Att'y. Gen. 124 (June 2, 1967). For a more extensive development of franchising under the California Corporate Securities Law, see Note, *Franchise Regulations under the California Corporate Securities Law,* 5 San Diego L. Rev. 140 (1968).

6. Compare 12 Op. Cal. Att'y. Gen. 23 (1948).

7. 49 Op. Cal. Att'y. Gen. 124–25 (1967).

http://digitalcommons.law.ggu.edu/callaw/vol1967/iss1/3

of the franchised business and that the business form "differs in name only from the 'limited partnership' agreements that were held to be securities in *People v. Hoshor*."[8] He further stated that the same result would obtain even if the contract permitted the franchisee to elect either an active or only nominal role in the actual management of the business. If such an option appears in the contract, the Attorney General would view it as an offer to sell a security and therefore as being within the scope of the Corporate Securities Law.[9]

As to the second situation, it was clear to the Attorney General that no security would be involved because "the profit will be attributable to the franchisee's own efforts" and hence the situation would fall within the category of agreements to which the Corporate Securities Law is not applicable.[10]

The third situation has a common element with the second situation insofar as the profits derived by the franchisee would again be due to his own effort. The Attorney General said, however, that the furnishing of initial capital to the franchisor "seems to us to be a separate business risk apart from the success or failure of the franchisee's conduct of the franchised business. . . ."[11] Such a business risk was felt to be within the scope of the Corporate Securities Law because, citing *Silver Hills Country Club v. Sobieski*,[12] "its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another."[13]

8. 49 Op. Cal. Att'y. Gen. at 126. For arguments on behalf of not holding such a contractual arrangement to be a security see Coleman, *A Franchise Agreement: Not a "Security" under the Securities Act of 1933*, 22 Bus. Law 493 (1967).

For People v. Hoshor see 92 Cal. App.2d 250, 206 P.2d 882 (1949).

9. See Securities & Exchange Comm. v. W. J. Howey Co., 328 U.S. 293, 90 L.ed. 1244, 66 S.Ct. 1100, 163 A.L.R. 1043 (1946).

10. See People v. Syde, 37 Cal.2d at 768, 235 P.2d at 602–03 (1951).

11. 49 Op. Cal. Att'y. Gen. 124, 129 (1967).

12. 55 Cal.2d at 815, 13 Cal. Rptr. at 188, 361 P.2d at 908, 87 A.L.R.2d at 1139 (1961).

13. 49 Op. Att'y. Gen. at 128 (1967).

Published by GGU Law Digital Commons, 1967

The commissioner adopted these opinions in Bulletin 67–8, where they were summarized as follows:

> [A] franchise constitutes a security subject to the permit requirement of the Corporate Securities Law where either the franchisee is to take a passive role in the franchised business, or a substantial portion of the initial risk capital of the franchisor is to be contributed by the franchisee.

The difficult question here, of course, is what constitutes the providing of initial capital so as to create an investment risk as distinguished from a payment to an established franchisor for the granting of the franchise and the providing of goods and services. The Attorney General ventured that he could provide no definite guidelines to resolve this question and that each case would have to be examined on its merits.[14] The commissioner, however, listed some factors helpful in resolving the question. The factors all relate to how well established the franchisor is—whether he already has sufficient capital when the franchisee arrives on the scene, whether he has a history of successful operation, and whether he already has an organization adequate to meet his commitments to the franchisee. The commissioner thus eliminated some of the guesswork regarding the scope of the Corporate Securities Law.

Unincorporated Associations

The legislature made several changes to the Corporations Code and the Code of Civil Procedure that pertain to partnerships and other unincorporated associations. A new part[15] was added to the Corporations Code which defines the legal characteristics of, and filing provisions for, unincorporated associations. The provisions apply to all "unincorporated organizations of two or more persons, whether organized for profit or not," except governmental agencies. Governmental

14. 49 Op. Att'y. Gen. at 129 (1967).

15. Cal. Corp. Code §§ 24000–24006, to Title 3.

Business Associations

agencies may be "persons," however, and therefore component parts of unincorporated associations.[16]

Corporations Code section 24001 gives an unincorporated association an entity status with respect to liability to nonmembers for "an act or omission of the association, and . . . of its officer, agent or employee acting within the scope of his . . . agency . . . ."[17] Such entity liability arguably already existed in California in torts,[18] but probably did not exist as to contractual obligations,[19] absent express statutory provisions to the contrary.[20] The provision, however, specifically leaves undisturbed the law that determines liability between an association and its members. Section 24002 provides that "only the property of the unincorporated association may be levied upon under a writ of execution issued to enforce a judgment against the association," a result previously accomplished by Code of Civil Procedure section 388.

Under the provisions of new section 24003 (a) (1) (2), an unincorporated association having a regular place of business within California may, at its discretion, file a form designating the location of its principal office in the state and may further designate either a natural person or corporation as agent for service of process. If the association has no office in the state, it may designate an address for receipt of notices.[1] Subsections (b), (c), and (d) of section 24003 proceed to spell out in detail the requirements for the filing of a designation of an agent or of a principal location within the state and the effect of the filing of an amending statement by unincorporated associations. If an agent is designated in accord-

16. Cal. Corp. Code §§ 24000(a), (b).

17. This provision settles any question of whether the provision allowing suit against an association under its common name (Cal. Code Civ. Proc. § 388) was merely procedural and hence whether any entity liability existed. See Comment, *Liability of Members and Officers of Nonprofit Unincorporated Assoc. for Contracts and Torts*, 42 Calif. L. Rev. 812, 814–18 (1954).

18. See Inglis v. Operating Engineers Local Union No. 12, 58 Cal.2d 269, 23 Cal. Rptr. 403, 373 P.2d 467 (1962).

19. See Pacific Freight Lines v. Valley Motor Lines, Inc., 72 Cal. App.2d 505, 164 P.2d 901 (1946); Security-First Nat'l Bank v. Cooper, 62 Cal. App.2d at 666, 145 P.2d at 729 (1944).

20. See, for example, Cal. Corp. Code § 21200.

1. Cal. Corp. Code § 24003(a)(1)(2).

ance with the provisions of section 24003, delivery of process by hand to such agent constitutes valid service on the association.[2]

This provision replaces the procedure of serving one or more of the association's members as the primary technique for service of process on associations. Service to members may still be made if no agent is designated or if the designated agent cannot be found at the address specified in the index described below.[3]

Corporations Code section 24004 provides for the creation and maintenance of an index of statements filed under the provisions of section 24003. A filed statement expires "five years from December 31 following the date it was filed."[4] The Secretary of State is authorized to destroy any such statement four years after the expiration date (or between nine and ten years after the original filing of the statement),[5] and may also delete any reference to the statement from the index at that time.[6] This provision will alleviate the problem of retention of outdated and inaccurate records. Deletion of such information from the Secretary of State's index may have adverse effects on a foreign partnership subject to the provisions of section 15700, discussed below, because service of process may thereafter be made on the Secretary of State and actual notice may never occur. Provision is made, however, for notification by the Secretary of State to any unincorporated association that has filed a statement under the provisions of section 24003 when the statement has expired because of lapse of time[7] or because of a resignation of the designated agent.[8] Nevertheless, failure of the Secretary of State to accomplish such notification will provide no protection for an unincorporated association whose statement is no longer effective.[9]

Foreign partnerships not having a regular place of business in California will be similarly treated. They will be

2. Cal. Corp. Code § 24003(e); Cal. Code Civ. Pro. § 411(2.1).

3. Cal. Code Civ. Pro. § 411 (2.1).

4. Cal. Corp. Code § 24003(d).

5. Cal. Corp. Code § 24004(a).

6. Cal. Corp. Code § 24004(e).

7. Cal. Corp. Code § 24006.

8. Cal. Corp. Code § 24005.

9. Cal. Corp. Code § 24006.

required, under the amended provisions of section 15700, to file a designation of agent as provided in new section 24003, discussed above. The amendment to section 15700 also allows a foreign partnership to designate, in accordance with section 24003, a corporation, instead of a natural person as was previously required, as agent for the partnership upon whom process may be served in the State of California.[10] The designations will be indexed as provided in new section 24004. If the designation has not been made or if service cannot be made on the agent designated in the index, the amended section provides for personal service on the Secretary of State, as under the previous law. Such personal service, however, must now be accompanied by "a written statement signed by the party to the action seeking such service, or by his attorney setting forth the last-known address of the partnership. . . ."[11]

Other additions and amendments made in order to clarify the legal status of, and procedures applicable to, an unincorporated association are found in sections 388, 395.2, 410 and 411 of the Code of Civil Procedure. Section 388 of the Code of Civil Procedure makes it clear that any unincorporated association "may sue and be sued in the name which it has assumed or by which it is known."[12] Under the previous law, partnerships and other unincorporated associations could be sued, but could not sue,[13] in their assumed names.

New section 395.2 of the Code of Civil Procedure makes the proper venue of an action against an unincorporated association identical to that of a corporation if the association has filed a statement listing the location of its principal office pursuant to section 24003. Under article XII, section 16 of the California Constitution, the proper venue for the two business forms was already identical except that the pro-

10. This amendment gives foreign partnerships the same privilege of utilizing a corporation as its agent for service of process that domestic and foreign corporations doing business in California have long enjoyed under the provisions of Cal. Corp. Code §§ 3301 and 6403, respectively.

11. Cal. Corp. Code § 15700.

12. Cal. Code Civ. Pro. § 388(a).

13. Case v. Kadota Fig Assn., 35 Cal. 2d at 602, 220 P.2d at 916 (1950); Grand Grove of U.A.O.D. v. Garibaldi Grove No. 71, 130 Cal. at 119, 62 P. at 487 (1900).

Published by GGU Law Digital Commons, 1967

vision for suit "in the county where the principal place of business . . . is situated" was thought to be inapplicable to associations.[14]

Section 410 of the Code of Civil Procedure, which deals with the proper method of service and return of summons, has been amended by replacing the phrase "against associates conducting business under a common name" with the newly defined term "unincorporated association" without working any substantive change. Amendments to section 411 set forth the proper persons to whom service of process must be made in a suit against an unincorporated association.[15] In the case of an unincorporated association other than a foreign partnership, service shall be made on an agent designated by the unincorporated association in accordance with the provisions of section 24003 of the Corporations Code. If it has chosen not to designate such an agent, or if the agent cannot be found at the address specified in the index, then service must be made "to any one or more of the association's members and by mailing the copy thereof to the association at its last known mailing address."[16]

California's Uniform Limited Partnership Act was changed to allow the amendment of a partnership certificate in the case where a partnership has twenty-five or more limited members by a procedure simpler administratively than that previously required. New Corporations Code section 15525.5 promulgates the new procedure.[17] Previously, any amendment to a certificate of partnership was required to "be signed and acknowledged by all members."[18] Partnerships with more than twenty-five limited partners, however, may now effect amendments over the signature of a general partner alone, if the partnership certificate so permits. Section 15525.5 contains an exceptional provision for those cases in which an amendment substitutes or adds a partner;

14. Juneau Spruce Corp. v. Int'l Longshoremen's Union, 37 Cal.2d at 762, 235 P.2d at 608 (1951).

15. Cal. Code Civ. Pro. §§ 411(2.1), 411(2.2).

16. Cal. Code Civ. Pro. § 411(2.1).

17. Cal. Corp. Code § 15508 was also amended to reflect the availability of the new technique.

18. Cal. Corp. Code § 15525(b).

it requires signatures of the persons joining and leaving the partnership as limited partners.

The judiciary was relatively inactive in the law of unincorporated associations during the past year. The Court of Appeal for the Second District, however, held directly for the first time that a partnership has no right to recover damages inflicted on a member of the partnership by a third party. In *Sharfman v. State of California,*[19] the individual plaintiff Sharfman was injured as a result of the negligence of the State of California. In addition to recovery being sought through plaintiff's individual causes of action, the partnership in which Sharfman was engaged as a landscape architect sought recovery for loss of profits. The partnership relied in part on the case of *Darmour Productions Corp. v. H. M. Baruch Corp.,*[20] which had held that a corporation may recover damages for a negligent injury to its employee. The court pointed out that the recovery in *Darmour* was based on a limited common-law principle that had been codified in section 49 of the Civil Code, which forbids "any injury to a servant which affects his ability to serve his master. . . ." The common-law liability of one who negligently injures a servant to the master of that servant is one of a limited number of relations that creates a right to recovery by a third person who might benefit from the services denied him by the injury suffered by another. Two similar principles, that a husband may recover for loss of services of his wife and that a parent may recover for loss of services of his child, continue to remain well recognized. The expansion of such principles to partnerships would have been an anachronism, however, since the principle on which it would be based, liability to a master, itself is under attack.[1] The probable basis for the dissatisfaction with the latter rule is the premise that the probability of a negligent person causing such harm is remote and unforeseeable.[2] Although the familial re-

19. 253 Cal. App.2d —, 61 Cal. Rptr. 266 (1967).

20. 135 Cal. App. 351, 27 P.2d 664 (1933).

1. See Seavey, *Negligent Harm to Servant,* Wash. U.L.Q. 309 (1956).

2. See Columbia Taxicab Co. v. Mercurio, 236 S.W. 1096 (C.A. Mo.

Published by GGU Law Digital Commons, 1967

Cal Law Trends and Developments, Vol. 1967, Iss. 1 [1967], Art. 3

lationships are to be anticipated, and recovery continues to be allowed for injuries in that area, damage to third parties resulting from a victim's partnership relationship is not reasonably foreseeable and hence falls within the general rule that negligent interference with the performance of a contractual relationship between the injured party and a third party is not actionable.[3]

1921); Prosser, TORTS, 964 (3d ed. 1964).

3. See Fifield Manor v. Finston, 54 Cal.2d 632, 7 Cal. Rptr. 377, 354 P.2d 1073, 78 A.L.R.2d 813 (1960).