State Blue Sky Jurisdiction over Foreign Corporations

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By JOHN G. SOBIESKI

In Western Air Lines, Inc. v. Sobieski, the California District Court of Appeal held that the California Commissioner of Corporations had jurisdiction under the California Blue Sky Law over the proposal of that Delaware corporation to change the voting rights on its shares to eliminate cumulative voting for the election of its directors. Although the California Supreme Court denied the company’s petition for a hearing, the case has been the subject of comment. Because of the interest which this case has aroused, this article will discuss the general subject of state Blue Sky jurisdiction over foreign corporations, of which subject this case is but a part, and comment briefly on cumulative voting.

Two types of laws—general corporation laws under which corporations are chartered, and Blue Sky laws, which regulate the “sale” of corporate securities—are involved in a consideration of state Blue Sky jurisdiction. Since, as Justice Holmes noted, the life of the law has been experience rather than logic, a brief review of items of past experience in this area may help put the subject in focus.

Blackstone stated that the king’s consent was “absolutely necessary” to the creation of a corporation. Early state legislatures, therefore, followed the practice of incorporation by special act. Although this gave

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* Commissioner of Corporations, State of California.


2 Cal. Corp. Code §§ 25000-26104. Its technical name is the Corporate Securities Law though it also applies to securities of non-corporate issuers. The article refers to it as the Blue Sky Law because that is the name under which such statutes are usually known in the United States.


5 In Western Airlines, Inc. v. Sobieski the plaintiff was but a “pseudo-foreign” corporation. Its business headquarters have always been in Los Angeles, California, from whence its air routes radiate; most of its employees reside in California; most of its shares are believed to be held by Californians, and its shareholders’ meetings have generally been held there. It does no business in Delaware. Delaware’s contact apparently consists in the fee it gets for the corporate charter.

6 1 Blackstone, Commentaries 472.
some legislative scrutiny to the proposed corporate activity, it apparently also caused angry charges of monopoly and favoritism. The consequence was the general incorporation laws of the early 19th century, opening corporate opportunity to all. They “sprinkled holy water on corporations” and are “a direct legacy from Jacksonian Democracy.”

The easy general incorporation laws (and the remarkable self-restraint of some courts) resulted in some deplorable practices towards investors. The view was also expressed that executives of corporations were in a system which made it difficult for them to follow ordinary standards of morality.

The general incorporation laws, as judicially interpreted, were said to permit the corporate management to have “as complete latitude and as little liability as possible” and the shareholders to have “as little power and as few enforceable rights as can conveniently be arranged.”

Commencing in 1910, so-called Blue Sky laws were enacted by many states. Only Nevada and Delaware do not now have some form of a Blue Sky law.

In general, Blue Sky laws required clearance of each securities offering with a state official and compliance with statutory standards designed to protect investors, a return to the individualized approach.

The purpose of the Blue Sky laws was “. . . (t)o protect the public against the imposition of unsubstantial schemes and the securities based upon them . . . which have no more basis than so many feet of blue sky,” and “. . . to afford those who risk their capital at least a fair

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5 Schlessinger, Jr., The Age of Jackson, 337 (1945).
6 See, e.g., 1 Mark Twain, Roughing It 243-44 (1899) (humorous accounts of Mining Swindles); 2 Mark Twain, supra at 17-19; 2 Mark Twain, supra at 136: “The bubble scarcely left a microscopic moisture behind it”; Swanberg, Jim Fisk 25 (1959): “The stock market at the time was an unregulated financial jungle ruled by the sharpest tooth and claw”; Swanberg, supra at 86: “What the Tweed Ring was in government, the Erie Ring was in finance.”; Swanberg, supra at 71: “Without asking a by-your-leave from the board of directors, Fisk and Gould secretly issued 235,000 shares of new (Erie) stock . . . .”; Swanberg, supra at 89: they “classified the road’s boards of directors into five groups. . . . Its real intent was to keep Gould and Fisk at the helm for a full five years . . . make it a more tractable creature for their Wall Street speculations.”
7 See, e.g., Norris, The Octopus, 285 (1901): “Blame conditions not men.”; Lewis, The Big Four, 211 (1938), in which the railroad president who, among other things, could travel from the Atlantic to the Pacific entirely on railroads he controlled was publicly described as having “no more soul than a shark” . . . “scrupulously dishonest” . . . “ruthless as a crocodile.”
9 Loss & Cowett, Blue Sky Law, 17 (1958). In 1931 Delaware enacted a rudimentary Blue Sky Law. It was later repealed after Nevada “boasted” that Nevada was the only state without a Blue Sky Law. See Hornstein, Corporation Law & Practice 71-72 (1959).
chance of realizing their objectives in legitimate ventures.”

The Blue Sky laws were “a means to the same purpose made necessary, it may be supposed, by the persistence of the evil and its insidious forms and the experience of the inadequacy of penalties or other repressive measures.”

The usual Blue Sky Law makes no express distinction between sales of securities by foreign and by domestic corporations. Should an exception for sales of securities by foreign corporations be implied?

Such exception, if made, could apply to most securities offerings. Certain corporations are in the business of arranging foreign (out of state) incorporations for others. A lawyer can phone such a firm, describe what he wants, pay the fees, and a charter from any state, as ordered, will usually be delivered in a day or so. The business of such incorporating concerns is extensive. For example, one advertises that it acts as Delaware agent for corporations whose total assets exceed $100,000,000,000. If a foreign charter, so easily obtainable, automatically granted an exception to the local Blue Sky law, the effectiveness of the latter against “the evil and its insidious forms” could be largely undermined.

A brief review of the laws, from the Blue Sky point of view, of two of the states where foreign charters could be obtained, Nevada and Delaware, will show the destructive effect which such exception could have.

Since neither of those states has a Blue Sky law, there apparently is no official scrutiny of the persons who are to be the corporate officers, directors, or managers. Thus, there appears to be no Delaware or Nevada procedure which would prevent notorious gangsters or convicted swindlers, for example, from being officers or directors or in charge of securities sales to the public by ventures incorporated in such states. (Most Blue Sky administrators check the past records of all officers, directors, and promoters as a matter of routine in acting on an application for a permit to sell securities, and refuse to clear an issue if the persons managing the company appear not to be of good business reputation.)

Section 153 of the Delaware Corporation Law authorizes the issuance of no-par shares “from time to time for such considerations as

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15 See, e.g., CAL. CORP. CODE § 25500.
16 THE CORPORATION TRUST CO., DELAWARE CORPORATION LAW i (1960).
fixed from time to time by the board of directors." § 17 Section 78.215 of the Nevada Corporation Law is substantially the same. Such sections would seem to authorize the issuance of shares "which have no more basis than so many feet of 'blue sky'."

Last year, following a proxy fight, a new group got control of a Delaware corporation which had many California shareholders. The new directors then engaged in activities which caused some shareholders to become restive and to commence organizing. The directors countered this by passing a by-law which abolished the right of shareholders to call special meetings of shareholders. Under this by-law even 100 per cent of the shareholders could not call a special meeting. (Under California law 20 per cent of the shareholders can always call a special meeting.) The law firm that represented the company reportedly advised that this by-law was legal under Delaware law. What is the philosophy of a corporation law that would permit 100 per cent of the shareholders to be stymied by their own directors? This by-law was voluntarily repealed by the board following a demand by the writer of this article. The jurisdictional basis for this demand will be mentioned later.

In another case, a Delaware corporation sought a California permit to merge with its wholly owned subsidiary. The merger would eliminate arrearages in cumulative dividends on the preferred shares by giving additional new and different shares to the old preferred shareholders. Counsel was asked what percentage of the preferred shares was required under Delaware law to approve the merger. The reply was that the preferred and common shares voted as one class and a simple majority of all votes was sufficient. Since the common shares were more numerous than the preferred, did this mean that the common shares could, in effect, decide whether or not the preferred would have their rights changed? The reply was that such was the Delaware law and a letter to that effect from a Delaware law firm was produced. Did dissenters have appraisal rights? The reply was that, under the procedure proposed to be followed, Delaware counsel advised that dissenters would have no appraisal rights. Counsel was thereupon advised by this writer that if a

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17 It has been intimated that such shares may even be issued as a gift. See Speakman v. Bernstein, 59 F.2d 520, 521 (5th Cir. 1932).
18 CAL. CORP. CODE § 2202.
19 "[T]hose in charge of the corporation are merely agents of the stockholders, who are the real owners of the property." Guthrie v. Harkness, 199 U.S. 148, 155 (1905).
20 Although, under Delaware law, arrearages in cumulative dividends may not be abolished by charter amendment, (Keller v. Wilson, 21 Del. Ch. 391, 190 Atl. 115, (1936)) apparently they can be wiped out in a merger. Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A.2d 331 (1940).
California permit were to be obtained, the vote of the preferred shares for the merger should be in percentages as great as those specified by California law for California corporations; a procedure granting appraisal rights to dissenters should be followed; the solicitation material should advise shareholders of their appraisal rights and how to exercise them if they chose to do so. The applicant appropriately changed its procedure, made a fair offer, and secured a permit. (The surviving corporation was a California corporation. This appears clearly desirable when, as in this case, the business and shareholders are primarily in California.)

Delaware or Nevada incorporation can also create dangerous problems for investors resulting from the mere fact of distance. Appraisal rights exercisable only in Delaware, for example, may be of questionable value to a California investor. Last year the management of a Delaware corporation, on a Friday, mailed to its shareholders, most of whom were Californians, a notice of a special shareholders meeting to be held in Delaware a week from the following Monday. (The shareholders' meetings had previously been held in California.) The meeting was to act on a proposal to issue a large block of shares to a New York corporation controlled by the management. Some California shareholders apparently received the notice of this Delaware meeting a week or less before the special meeting was to be held. California stock brokers thereupon requested the California Division of Corporations to take action to protect the California investors. A nice question was presented. Did the proposed transaction come within the jurisdiction of the California Blue Sky Law? The reported view of the legal firm advising the management was that it did not. (The company had previously applied for a California permit for the issuance of such block of shares but had failed to furnish information requested by the deputy commissioner which would bear on the value of the property to be given in exchange for the shares and the profits, if any, to insiders.) The company later voluntarily postponed the meeting at the request of the writer of this article and subsequently abandoned the possible conflict of interest transaction. But if shareholders' rights are exercisable only at a distant place, and possibly on very short notice they clearly are less effective than if exercisable locally and upon reasonable notice. Promoters, managements, and their counsel may sometimes be aware of this "advantage" of a foreign incorporation.

The above brief analysis of the Delaware and Nevada corporation laws, which are much the same, appears sufficient to demonstrate that they are designed primarily to please promoters and managements. Such view is consistent with the substantial portion of the total revenues of
such states which are collected for incorporation services rendered to companies which do no business there. It is the promoters and managements, not the shareholders, who ordinarily choose the state of incorporation.  

During the fiscal year ending June 30, 1961, approximately 17 per cent of the total revenues of the State of Delaware were reportedly produced by corporation organization fees and franchise taxes and 5.88 per cent of Delaware’s state revenues were reportedly collected from race tracks which likewise reputedly cater mainly to non-residents.

Nevada, like Delaware, also seeks major contributions to its state revenues from non-residents. Its famous “quickie” divorce law requires a 60-day Nevada residence (with money necessarily spent in Nevada) before the nuptial knot is legally snipped. For the fiscal year ending June 30, 1961, permits and license fees on gambling (done mainly by visitors) reportedly amounted to over 22 per cent of Nevada’s total revenues in fiscal 1961. Fees from corporations amounted to $409,304 or .87 per cent of total Nevada revenues.

Nevada officials reportedly toured the United States last year trying to impress promoters and corporate officials with the desirability of incorporating in Nevada. Nevada Governor Sawyer reportedly said that this effort to secure more incorporations was for the purpose of lessening Nevada’s economic dependency on gambling.

From the Blue Sky point of view, therefore, the fact that a corporation is incorporated in Delaware or Nevada is apparently no evidence whatever that the sales of its securities elsewhere do not need Blue Sky regulation. On the contrary, the evidence demonstrates that the need for Blue Sky regulation will ordinarily be most acute with respect to sales of securities of corporations incorporated in Delaware or Nevada.

Since it appears necessary to the effectiveness of state Blue Sky law regulation that it apply to sales in the state of securities of foreign

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21 “Says the chairman of a small Southern California manufacturing company which recently filed under the Nevada law: ‘We plan mergers for the future, and the California corporations commissioner makes you justify every move before letting you do anything at all. We’re more flexible under Nevada law.’” Wall St. Journal, June 1, 1961, p. 26, col. 2 (Pac. Coast Ed.). The Wall St. Journal later kindly printed a statement by this writer which said, in part: “If securities are to be sold in California a Nevada incorporation will grant no legal exemption under California law, particularly as to mergers which cannot pass muster under an impartial inspection.”

22 CCH STATE TAX CAS. REP., DEL. 186 (1962).

23 CCH, op. cit. supra note 22, at 187.

24 CCH, STATE TAX CAS. REP., NEV. 186 (1962).

25 Ibid.

26 Wall St. Journal, June 1, 1961, p. 26, col. 3 (Pac. Coast Ed.).
corporations, the question then arises whether there is any legal principle which prevents a state from so protecting its citizens.

Although such state Blue Sky regulation may burden interstate commerce, the courts have held such a burden to be merely incidental to the valid exercise of state police power. Furthermore, in 1933 Congress expressly acquiesced in state Blue Sky jurisdiction over securities sales involving interstate commerce.

The ordinary doctrines of conflicts of laws likewise appear to be no bar. The foreign corporation, by selling locally, thereby subjects itself to the local Blue Sky Law. Furthermore, recent developments in this area hold that a state's police power is not limited by mechanical conflict of laws concepts.

Recently there has been a tendency on the part of some states to depart from the general conflicts rule in order to take into account the interests of the State having significant contact with the parties to the litigation . . . . [S]ee the opinion of Mr. Justice Black in Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 161-162 . . . where is it stated in context to a different but analogous problem:

"In determining which contact is the most significant in a particular transaction, courts can seldom find a complete solution in the mechanical formulae of the conflicts of law. Determination requires the exercise of an informed judgment in the balancing of all the interests of the states with the most significant contacts in order best to accommodate the equities among the parties to the policies of those states."

If the state of incorporation is Nevada or Delaware, the "significant contact" is ordinarily that of having got a fee for a charter. The "significant contact" of the state with the Blue Sky law is ordinarily the purchase of securities by its citizens. If we balance the interests "to accommodate the equities" it is obvious that the right of the Blue Sky law state to protect its citizens against imposition in the sale of securities will necessarily prevail.

Even though the foreign state of incorporation should have a Blue Sky law, such law would still not appear to give the foreign state the most significant contact with respect to securities sold in another state. The purpose of the Blue Sky laws is to protect investors. The state

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27 Hall v. Geiger-Jones Co., 242 U.S. 539, 557-59 (1917); Travellers v. Virginia, 339 U.S. 643, 653 (1949) (concurring opinion). In Merrick v. Halsey, 242 U.S. 568 (1917), the Michigan Blue Sky statute was upheld against attacks by Ohio and South Dakota concerns, among others, who were affected by it.


29 See note 27 supra.


31 See notes 12 and 13 supra.
whose citizens are to pay their money clearly has the dominant contact so far as the protection of those investors is concerned. The Richards case makes this clear. The test is “which contact is the most significant in a particular transaction.”\textsuperscript{32} [Emphasis added.]

If a state generally has Blue Sky jurisdiction over sales of securities made in such state, is it necessary for jurisdictional purposes that the sale be entirely in the state, or is it enough that a substantial portion of the sale transaction be in the state? Each of three separate lines of reasoning demonstrates that the latter is enough.

Preliminarily, it should be noted that because of “the persistence of the evil and its insidious forms”\textsuperscript{33} most states define the term “sale” so broadly that any significant part of the sale transaction will ordinarily, by itself, be a “sale” within the meaning of the state Blue Sky Law. Thus, California defines “sale” to include, among other things:\textsuperscript{34}

\begin{quote}
[E]very disposition, or attempt to dispose, of a security . . . for value . . . whether done directly . . . or otherwise: An offer to sell; an attempt to sell; a solicitation of a sale; an option of sale; a contract of sale; a taking of a subscription; an exchange; any change in the rights, preferences, privileges, or restrictions on outstanding securities.
\end{quote}

Accordingly, the cases hold that the Blue Sky law may be violated even though transfer of title to the shares or a “sale” within the law of sales occurred only in another state.\textsuperscript{35}

A sale of securities in violation of the Blue Sky law is a crime.\textsuperscript{36} A state ordinarily has jurisdiction over crimes where only a part thereof was committed in the state, just as it does where the entire crime was committed therein.\textsuperscript{37}

Secondly, state courts have long exercised jurisdiction over acts done or to be done outside the state which are part of a larger transaction which materially affects state interests. Three illustrative examples follow:

a. One Hedley was manager of the Wells Fargo & Co. office at Gold Hill, Nevada. Unknown to his employer he had lost money speculating on the San Francisco Stock Exchange. Hedley, thereupon, sent

\textsuperscript{33} See note 14 supra.
\textsuperscript{34} CAL. CORP. CODE § 25009(a).
\textsuperscript{36} E.g., CAL. CORP. CODE §§ 26103-04 (Maximum penalty for individuals $5,000 fine and 5 years).
\textsuperscript{37} E.g., CAL. PEN. CODE § 778(a).
a telegram from Gold Hill, Nevada, to Wells Fargo & Co., San Francisco, California, directing it to pay a sum of money to Hedley's San Francisco broker. The telegram contained a code word which advised (untruthfully in this case) that Hedley on behalf of Wells Fargo & Co. had received said sum from a customer for transmittal. Wells Fargo & Co., in San Francisco, paid the sum to the broker. When Hedley was later charged with embezzlement in San Francisco, California, he sought release on habeas corpus because he was in Nevada when the embezzlement was alleged to have been committed in California. His application for release from custody was denied. 38

b. A California shareholder in an Arizona corporation sought an order from a California court that he might inspect the corporation’s gold mine located in Arizona. The directors resided in California and generally held their meetings there. The lower court, believing it lacked jurisdiction to order inspection of an Arizona mine owned by an Arizona corporation, gave judgment for defendants. The California Supreme Court reversed. 39

c. A California court exercised jurisdiction to order persons who controlled a Mexican corporation to cause that corporation not to take action in Mexico which would impede the flow of water from Mexico to California. 40

Thirdly, it is axiomatic in securities cases that substance prevails over form. 41 The substance of most securities distributions is a two way flow. On one hand there is a flow of money from the public to the issuer for the purpose of supplying capital to the issuer (after costs and selling expenses have first been deducted). On the other hand, there is a flow of securities from the issuer to the public in exchange for the public's money. If, therefore, money is flowing from citizens of the state to an issuer in exchange for its securities, it appears that the substance of the securities transaction is occurring in the state from which the money is flowing despite the technicality that, within the meaning of the law of sales, the sale may not have occurred entirely in such state. 42 If the substance of the transaction is looked to in accordance with established principles respecting securities regulation, then the state whose citizens are paying their money as part of this

38 Ex parte Hedley, 31 Cal. 108 (1866).
39 Hobbs v. Tom Reed Gold Mining Co., 164 Cal. 497, 129 Pac. 781 (1913); accord, SEC v. Minas De Artemesia, 150 F.2d 215 (9th Cir. 1945).
42 "[T]he devices to avoid state regulation have been clever and calculated." Travellers v. Virginia, 339 U.S. 643, 653 (1950) (Douglas, J., concurring).
flow would seem to have jurisdiction to establish Blue Sky regulation to protect its citizens against imposition.

If, then, a state has Blue Sky jurisdiction over the sale of securities of foreign corporations whenever a substantial part of such sale occurs in the state, may the state properly define such a sale to include “any change in the rights, preferences, privileges or restrictions on outstanding securities”?43

Such a provision, added to the California code in 1945,44 confirmed prior administrative interpretations.45 The validity of this provision, which contains no exception for foreign corporations, does not appear to have been questioned in any court. Even the Western Air Lines, Inc. brief did not appear to challenge it.

This provision, of course, does not prohibit changes in outstanding securities. It merely requires such changes to conform to the standards of fairness which are required in the original sale of the securities and thereby helps to achieve the regulatory purposes of the Blue Sky law. It helps to maintain the integrity of what has been sold. Managements and promoters should not be permitted to play a shell game with securities. What boots it that securities must be fair when sold if, immediately after the money has been collected, they can be converted into unfair securities?46

It is argued by some that this regulation is unnecessary because changes in securities ordinarily may be made, under Delaware or Nevada law for example, only by at least a majority vote of the shareholders. Such an argument is not persuasive. In many cases the promoters or management are in a position to directly control the vote of a majority of the shares. In such cases the public shareholders would be dependent on the “good nature”47 of the promoters or management as to how they will be affected by the changes. In those cases where the promoters or management do not directly control a majority of the votes, the shareholders, in voting on changes, are ordinarily dependent on the management for information as to the proposed

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44 Cal. Stat. 1945, Ch. 399 § 8, p. 854.
46 The Delaware statutes, for example, do not contain a “fairness” test in recapitalizations. See Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 Atl. 255 (1929).
47 See notes 8 and 9 supra.
changes.\textsuperscript{48} The SEC regulations requiring annual and other reports to shareholders and reasonable disclosure in proxy solicitations are unfortunately limited, by statute, to companies with securities listed on stock exchanges. Attempts in the Congress to extend these rules to other companies have so far been successfully opposed by special interests.\textsuperscript{49}

There is another reason why the requirement of a shareholder vote does not eliminate the need for Blue Sky regulation of changes in securities. In the original distribution of the securities the people who buy are primarily only those who consent to buy; i.e., those who buy as a result of physical coercion, duress, and the like are believed to be relatively few. There is, therefore, approximately 100 per cent consent so far as the original purchasers are concerned. But such consent is not evidence that Blue Sky regulation is unnecessary. On the contrary, Blue Sky laws have been enacted primarily to protect those who would consent.

The need for Blue Sky regulation of changes in securities is recognized by legal scholars. It was the judgment of California’s great legal scholar in the corporation field that state Blue Sky regulation of recapitalizations and reorganizations is essential for the protection of investors:\textsuperscript{50}

A requirement that the fairness of the terms and conditions of such an exchange be approved by some impartial administrative officer is a far more effective method of regulation than the almost useless judicial remedies which are afforded by a suit for injunction or by the compensation of dissenting shareholders. In fact such regulation seems to offer the only hope of preventing unfairness in such fundamental changes as to which the shareholders do and must rely almost exclusively upon representations made to them by the management of the issuer. (Emphasis added.)

Professor Dodd of Harvard:\textsuperscript{51}

It may be that an extension of administrative control over recapitalizations by federal or perhaps state administrative agencies to other types of corporations is the best possible solution to the recapitalization problem—one is tempted to say the best curb for the recapitalization racket.

\textsuperscript{48} Ballantine, Corporations 880-881 (Rev. Ed. 1943). “The value of securities consists in what they represent, and to determine such value is a complex problem even to the most skillful and informed.” Hall v. Geiger-Jones Co., 242 U.S. 539, 552 (1917).

\textsuperscript{49} “[E]ach time the Association has been effective in its opposition.” Annual Report, National Association Securities Dealers, Inc., 4 (1959).

\textsuperscript{50} Ballantine, Corporations 880-881 (Rev. Ed. 1946).

\textsuperscript{51} Dodd, Fair and Equitable Recapitalization, 55 Harv. L. Rev. 780, 816 (1942).
Emphasizing the need for investor protection:

Judicial control of recapitalization is of limited significance in almost every state. In view of the difficulties and expense faced by minority shareholders in seeking relief and the traditional reluctance of courts to interfere in corporate affairs, solution of the freezeout problem may lie in the use of an administrative agency. To follow the argument of Western to its conclusion, would be to say that the commissioner might have the power in the first instance to require certain rights to be guaranteed to shareholders before he would permit the sale or issuance of a foreign corporation’s stock in this state but that, immediately thereafter by the device of amending the charter of such corporation in another state, the entire structure of that corporation, even to substantial changes in the rights of shareholders in California could be legally effected. Such a holding would enable a foreign corporation to destroy the rights which the State of California has deemed worthy of protection by the enactment of the [Blue Sky Law].

After a detailed study of 15 years’ operation of such Blue Sky regulation of securities changes, an eminent scholar concluded that “The result is a system in California which more effectively protects security holders than have the courts in other states.” In view of the foregoing, it appears that a state may properly conclude, and act on the conclusion, that its Blue Sky police power includes the power to regulate changes in outstanding securities of foreign corporations held by its citizens. A state is not impotent to protect its citizens against sharp corporate practices by foreign corporations.

Such regulation in its penal aspects appears subject, of course, to the basic jurisdictional requirements that the person against whom such regulation operates be either found in, or extraditable into, the state.

The arguments against state Blue Sky jurisdiction over changes in rights in securities of foreign corporations appear to fall under two heads. One argument seems to be that such Blue Sky action is vulnerable because it does not give full faith and credit to the law of the state of incorporation. The other argument seems to be that, for

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56 "The question is almost entirely unexplored and anything said on the subject must be in the nature of an opinion.” Reese & Kaufman, The Law Governing Corporate Affairs, 58 COLUM. L. REV. 1118, 1144 (1958).
business reasons, it is desirable to have uniformity in the law governing corporate securities and that therefore a state, other than the state of incorporation, lacks jurisdiction to impose Blue Sky regulations on changes in securities.\(^5\)

The claim that a Blue Sky law regulating changes in securities does not give full faith and credit to the foreign law appears doubtful for several reasons. First, full faith need not automatically be given to a law which is against the public policy of the forum state.\(^6\) The public policy of the Blue Sky states is that their citizens are entitled to Blue Sky protection. For Delaware or Nevada, for example, to impose corporate practices of "easy virtue" on Blue Sky states would apparently violate the latter's public policy. Delaware's, or Nevada's, fiscal profit from credulous persons elsewhere\(^6\) does not appear to be thus constitutionally guaranteed.\(^6\) Second, the argument proves too much. The Delaware law and the Nevada law, by their terms, avoid Blue Sky regulation in the initial sale of securities as well as in their subsequent changes. (As previously shown, the power of the Blue Sky states to regulate the initial offering is now unquestioned.) If it denies full faith and credit to impose Blue Sky regulation on changes in securities why does it not also deny full faith and credit to impose Blue Sky regulation on the original sale, in other states, of securities of Delaware or Nevada corporations?

The other argument against state Blue Sky jurisdiction appears to be this: since it is desirable to have uniformity in the law regarding securities, the law of the state of incorporation\(^6\) must control as to all matters relating to the corporation's securities and, therefore, a state lacks jurisdiction to impose Blue Sky regulations which could affect the validity of securities of foreign corporations.\(^6\)

But while uniformity is desirable, here as in other fields, any assertion that the constitution commands arbitrary uniformity and that

\(^5\) Reese & Kaufman, supra note 56, at 1126.
\(^6\) See note 21 supra.
\(^6\) "[T]he conflict is to be resolved, not by giving automatic effect to the full faith and credit clause, compelling the courts of each state to subordinate its own statute to those of the other, but by appraising the governmental interests of each jurisdiction, and turning the scale of decision according to their weight." Alaska Packers v. Ind. Acc. Comm., 294 U.S. 532, 547 (1935).

\(^6\) But see, Latty, Pseudo-Foreign Corporations, 65 Yale L.J. 137, 173 (1955): "[A]nd other legal systems have long rejected the notion that the law of the chartering state automatically governs. Instead, there must be legal compliance with the law of the place where the corporation has its 'social seat.'" 

\(^6\) Reese & Kaufman, supra note 50, at 1144. See also Note, 46 Minn. L. Rev. 785 (1962).
it be achieved in one particular way appears unsupportable. Furthermore, the legitimate desire for uniformity must not be perverted into a Trojan Horse with which to destroy other states’ standards of corporate conduct. If Delaware and Nevada could give the law to the rest of the land that result could soon follow although, of course, it might thereby lessen Nevada’s and Delaware’s revenue dependence on gambling.

In addition, this uniformity argument also apparently proves too much. Blue Sky laws, such as California’s, may declare securities sold in violation of such laws to be void.\footnote{\textit{CAL. Corp. Code} § 26100.} (In practical effect the word “void” means voidable at the option of the purchaser.\footnote{Dahlquist, \textit{Regulation and Civil Liability Under California Corporate Securities Act}, 34 \textit{Calif. L. Rev.} 544, 554 (1946).}) If such a provision is proper, as apparently it is, with respect to the original sale of securities, then why is it improper when applied to changes in securities in violation of a state Blue Sky law?

If, in recapitalizations, all states must subordinate their public policies to the law of the state of incorporation (which might be Delaware or Nevada) we must frankly recognize that this would enable “a foreign corporation to destroy the rights which the State of California has deemed worthy of protection.”\footnote{Western Air Lines, Inc. v. Sobieski, 191 Cal. App. 2d 399, 413-414, 12 Cal. Rptr. 719, 729 (1961).} Such a blow to state authority appears flatly contrary to what the Supreme Court has said about state Blue Sky regulation.\footnote{“The state must adapt its legislation to evils as they appear, and is not helpless because of their forms.” Merrick v. Halsey & Co., 242 U.S. 568, 588 (1916).}

At the present time if a corporation wishes to sell its securities it ordinarily must comply with the Blue Sky laws of each state where it sells (as the word “sell” is defined in each Blue Sky law.) If its shares have preemptive rights it presumably must comply with the Blue Sky law of every state in which its shareholders reside (and make them an offer) before it can sell additional shares. If the corporation wishes to grant stock options to its executives it presumably must first comply with the Blue Sky law of each state in which its executives reside. If the corporation wishes to establish a profit sharing or pension plan for employees, particularly if, as a part thereof, the employees contribute towards the purchase of the company’s shares, it ordinarily must comply with the Blue Sky law of each state in which its employees reside. The various Blue Sky laws have exemptions and some of the above transactions may be exempt in some states, but apparently the states have Blue Sky jurisdiction in each of the above matters.
In each of the above situations uniformity of state action ordinarily appears desirable. In each case fears of chaos and the like could be apprehended from conflicting or arbitrary state actions. Yet state Blue Sky jurisdiction is not seriously questioned.

Lack of jurisdiction, of course, cannot be founded on any fears that the Commissioner would act arbitrarily.67

Where uniformity in state Blue Sky regulation appears desirable it can generally be achieved. Since the objectives of Blue Sky laws are much alike, the administrators often voluntarily adopt similar approaches.68 When a securities issue is being offered in more than one state it is not unusual for administrators to pool information. Statements of policy are agreed to by administrators in conventions which, while not legally binding, are intended to help achieve uniformity of treatment.69 Securities administrators throughout the United States consciously try to ease the path of legitimate business in every way which is consistent with the protection of investors and the due administration of law.

It has been asserted by some that such uniformity often means that the company must comply with the Blue Sky laws of the toughest state. But even if that were true, which is not always so, is that less preferable than the alternative, i.e., under the guise of “uniformity” to comply with no Blue Sky laws if the promoters “happened” to incorporate in Nevada or Delaware? And can the latter view be raised to the dignity of a constitutional command?70

Let us examine the uniformity argument from a different angle. A given corporation has securities outstanding which were sold in compliance with the local Blue Sky laws. All is uniform. Someone wants to change the securities. Until the change is made, all is still uniform. If application is made in compliance with local Blue Sky laws applying to changes in securities, the same problems may arise as when the securities were originally sold, or when rights offerings are made shareholders, or options granted executives, or investment plans offered employees. In each case counsel must convince the commissioners that the proposal is fair. But if the proposal is fair, that can

67 “Besides, we repeat, there is a presumption against wanton action by the Commission, and if there should be such disregard of duty a remedy in the courts is explicitly given, and if it were not given it would necessarily be implied.” Merrick v. Halsey & Co., supra note 66, at 590.
68 A recently adopted uniform form of application to sell securities (Form U-1) is acceptable in many states, for example.
70 See note 66 supra.
be done. Last year, the California Division of Corporations, for example, issued over 18,000 permits, in each case finding, among other things, that the proposed offering was fair.

Since the objectives of all state Blue Sky laws are much the same, relatively few cases should arise in which the commissioner in one state would require things which a commissioner in another state would forbid. The obvious step, if that ever did occur, would be to arrange a telephone conference between the commissioners. If their conflicting attitudes could not be resolved, and if it was felt that a state was acting arbitrarily, we would appear to have a proper case for judicial review. It can be assumed that the judiciary can capably solve, on an individualized basis, any few such interstate conflicts as cannot administratively be taken care of.\(^7\)

No basis for lack of state Blue Sky jurisdiction exists because "mechanical formulae," or alleged need for uniformity, appears present. Furthermore, the question in such rare cases like those when a state’s refusal to permit the original sale of securities is challenged, would appear to be whether the state exercised its jurisdiction arbitrarily, not whether it had jurisdiction. In making such a determination a prime consideration would apparently be the basic fairness or unfairness of the proposed change. If the fairness, as general Blue Sky standards measure fairness, were at all doubtful it is difficult to see how the position of the objecting state could be overcome.

A serious problem can arise, however, if management, without complying with the local Blue Sky laws, purports to change securities. In such a case are the changes valid? Many awkward questions can arise but one point seems clear. The purpose of the Blue Sky laws is to protect investors. If such laws can be circumvented by the simple device of not complying and then pointing to the difficulty of unscrambling the mess caused by non-compliance, there would be a loophole which is really colossal.

This article will conclude with a brief analysis of the issue which

\(^7\) The resolution of such conflicts presumably would involve "the balancing of all the interests of the states with the most significant contacts," Richards v. U.S., 169 U.S. 1, 13 (1962). Also, "appraising the governmental interests of each jurisdiction, and turning the scale of decision according to their weight." Alaska Packers v. Ind. Acc. Comm., 294 U.S. 532, 547 (1935).
triggered the *Western Airlines* case: cumulative voting. More elaborate discussions can be found elsewhere.

The merit—or vice, depending on one’s viewpoint—of cumulative voting, which has been mandatory for ordinary California corporations since 1879, is that it permits representation of minority shareholders on the board of directors. This touches basic principles. According to J. S. Mill, “it is an essential part of democracy that minorities be adequately represented.”

Assume a corporation with only five shareholders, each owning one share. If there were five directors then, under cumulative voting, each shareholder could always elect one director. Under straight voting, however, three of the shareholders, if they wished, could always elect all of the directors thereby excluding 40 per cent of the shares from representation on the board.

A director, in addition to his other powers, usually has almost unlimited right of access to corporate records and information. It could hardly be otherwise if he is to properly exercise his duties as a director. In the case above, the owners of 40 per cent of the shares are not only excluded from representation on the board, but they are excluded from the full corporate information which directors are entitled to have. They see, on the other hand, at least two directors with no investment in the company enjoying the power and emoluments of directorships.

In the case above, the owners of 60 per cent of the shares elect 100 per cent of the directors. Suppose the board enters into a contract with corporation “A”, which is 100 per cent owned by members of the board. The directors stand to gain 100 per cent of the profits of “A” while, in the given corporation, 40 per cent of any loss will be borne by shares which are unrepresented on the board. In some corporations the directors may own few shares but still control the proxy machinery as officers. In such cases it can appear to be to their short range personal advantage if the corporation they direct, and in which they have but a small stock interest, enters into an unprofitable contract with another corporation.

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72 CAL. CORP. CODE § 2235: “Every shareholder entitled to vote . . . may cumulate his votes and give one candidate a number of votes equal to the number of directors to be elected multiplied by the number of votes to which his shares are entitled, or distribute his votes on the same principle among as many candidates as he thinks fit.”


74 JOHN STUART MILL, *Representative Government* (1861).

75 E.g., CAL. CORP. CODE § 3001. His right to inspect corporate books, properties, etc., is “absolute.” CAL. CORP. CODE § 3004.
contract with another corporation in which they have a more substantial stock interest.

In larger corporations the need for cumulative voting appears even more acute. There the management, through control of the corporate proxy machinery, may become "an autocratic self-perpetuating oligarchy." When corporate salaries, fringe benefits, stock options, possible conflict of interest transactions and the like arise, how can a board properly act when the board itself may be subject to dismissal whenever the management decides to use the proxy machinery differently? In passing on such important and delicate questions, how is it possible to compare a director who owns a few or no shares, craves the fees and prestige of his directorship, and who knows his tenure as director depends on management's good will toward him, with a director who is elected by cumulative voting, who owns or represents a large number of shares, and who is secure in his directorship regardless of whether he votes against a stock option for the corporate president?

These crucial problems are appreciated by some managements. In some corporations, very large stockholders sit on the board. Some boards have a salary and bonus committee made up in large part of elder members who presumably can take a detached view of these delicate problems. Such voluntary procedures, effective though they may be in particular cases, do not appear to be required by law and certainly they are not followed by all corporations.

A solution which the law can impose is cumulative voting. Through it one or more "independent directors," to use Lewis D. Gilbert's felicitous words, can be elected who would not be obligated to management for appointment or tenure. Is not the possibility of electing "independent" directors through cumulative voting a desirable development if we wish corporate integrity to rest on a more substantial base than good intentions? On the other hand where management in effect selects all of the directors we have the tail wagging the dog.

Arguments against cumulative voting fall under two heads. In the hearings conducted prior to adoption of voting rules under the California Blue Sky law it was argued by counsel that a director who owned few shares was, on principle, "better" than a director who was a large shareholder. The latter, it was asserted, was interested in his shares, the former in the good of the corporation. This argument, it seems, is contrary to all experience. It is not in accord with the Holy Writ which says that where a man's treasure is, there also is his heart.


It was argued that shares which cannot elect directors are nevertheless "represented" by all the directors who, of course, owe a legal duty to all shareholders. That appears to be a play on the word "represents." Having a director who owes you such legal duties as you can enforce in courts is materially different from having a director whom you have chosen.

It was argued that directors elected by cumulative voting would act for the shareholders who elected them, while directors elected by the management's proxy machinery would represent "all" the shareholders. One management asserted in its proxy statement that, "Cumulative voting may open the way for partisanship among board members and for special interests to obtain board representation." This is a form of the "papa knows best" argument. To have board members who own or represent enough shares to be elected under cumulative voting means directors with a real stake in the company. If the basic assumptions of capitalism are sound, that is superior to a "harmonious" board subject to dismissal by the group controlling the proxy machinery.

It is argued that cumulative voting must be undesirable because many corporations do not have it. The answer to this is, regrettably, that many promoters and managements still try, to the extent the law permits, to get as great personal latitude as possible and to give the shareholders as little power as can conveniently be arranged.

The distinguished financial editor of the San Francisco Chronicle, Sidney P. Allen, has said:\textsuperscript{78}

\begin{quote}
[I]t will no longer do to hide behind the old Wall Street notion that there's really no parallel between democracy in government and democracy in corporations. . . . The courts of the land . . . recognize that corporate democracy is a real part of our life. And they are not ready to permit minority rights like cumulative voting to be short circuited.
\end{quote}

Cumulative voting in corporations is supposed to have been started by the great Joseph Medill, of Chicago, an early backer of Abraham Lincoln. Writing in support of the proposal to put cumulative voting for directors into the Illinois Constitution of 1870 (it was placed in the California Constitution in 1879), Medill wrote: "It can do no harm. It will certainly do an immense amount of good. It is in the right direction—in the direction of honesty and of protection to the property, and the interests of shareholders in private corporations."\textsuperscript{79}

\textsuperscript{78} Investment Dealers Digest, June 5, 1961.
\textsuperscript{79} GILBERT, STOCKHOLDER ACTIVITIES AT CORPORATION MEETINGS 184 (1961).