

1-1962

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### Recommended Citation

Michael De Vito, *Necessity and Method of Obtaining the Negotiating Permit*, 14 HASTINGS L.J. 153 (1962).

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# COMMENTS

## NECESSITY AND METHOD OF OBTAINING THE NEGOTIATING PERMIT

By MICHAEL DE VITO\*

SECTION 25500 of California's Corporate Securities Law provides, in part, that:

No company shall sell any security of its own issue, except upon a sale for a delinquent assessment against a security made in accordance with the laws of this State, or offer for sale, negotiate for the sale of, or take subscriptions for any such security, until it has first applied for and secured from the commissioner a permit authorizing it so to do.

The word "sale" above includes solicitation of security holders to consent to any changes in the rights, preferences, privileges or restrictions of their outstanding securities.<sup>1</sup> Thus, a permit is required not only for the *issuance or sale* of securities but also for "any change in the rights, preferences, privileges or restrictions" inherently a part of the securities already outstanding.<sup>2</sup>

All references in this comment to corporate securities for which permits are required are confined either to newly issued, non-exempt securities or to securities which are resold by the issuer itself. This limitation is made because the permits to be discussed are not required to be obtained in connection with securities which are resold by one other than the issuer, exempt, or issued to a broker or an authorized financial institution.<sup>3</sup>

The permit referred to in section 25500 is commonly called the "definitive permit" because it requires the exact details of the proposed corporate issue, sale or change in existing securities. It is the signification that the Corporations Commissioner has authorized, but not recommended, that particular issuance, sale or change. The information required for the issuance of this permit is so definite and detailed that it necessarily presupposes an agreement as to the terms of the corporate

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<sup>1</sup> CAL. CORP. CODE § 25009(a).

<sup>2</sup> See Dahlquist, *Regulations and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343 (1945).

<sup>3</sup> CAL. CORP. CODE §§ 25100, 25102, 25151, 25152, 25155, 25156, 25180.

issue. If, in fact, there is no such agreement as to terms, then the parties must discuss proposals at variance with those authorized by the permit. Once these discussions can be interpreted as negotiations, under the provisions of section 25500, the securities issued come under the prohibitions of the section. Moreover, securities issued without, or not in conformity with, the definitive permit are void.<sup>4</sup> The resultant obstacles to business negotiations involving securities of a company's own issue led to the use and codification of the negotiating permit, formerly called an offering permit.

In 1957 two sections were added to the California Corporations Code. Section 25516 provides for "the offer, negotiation or taking of subscriptions for the sale of securities" after filing of a verified application and obtaining permission of the Corporations Commissioner. Section 25517 stipulates that:

The issuance of such a negotiating permit shall be conditioned to the effect that none of the securities shall be sold or issued nor shall any consideration be received or accepted in connection therewith unless and until a permit shall have been applied for and issued pursuant to Chapter 4, Division 1, Title 4 of the Corporations Code.

These new sections, taken in conjunction with section 25500 and other related sections, now facilitate the negotiation of contracts involving corporate securities. A contract involving the issuance or sale of securities having been properly entered into under the protective auspices of a negotiating permit is not subject to attack as having violated section 26100 of the Corporations Code. Such a violation would have made the contract unenforceable since the securities issued under it would have been void.<sup>5</sup> Additionally, it is at once obvious that the original protection afforded by the definitive permit is completely retained. Any contract signed is still conditioned upon the issuance of the definitive permit and therefore the same determination of whether the plan is "fair, just and equitable" will still be made by the Commissioner.<sup>6</sup>

There are several cases where the negotiating permit is not required. On the one hand there is an exempt class of securities, and on the other there is an exempt class of individuals and agencies dealing with securities. It is at once obvious that a negotiating permit is not necessary

<sup>4</sup> CAL. CORP. CODE § 26100. It is more accurate to say that these securities are not void but are only voidable. See Haakh, *The Amorphous Concept "Void" of Corporations Code Sec. 26100*, 29 L. A. BAR BULL. 292 (1954).

<sup>5</sup> *Ibid.* See *Stonehocker v. Cassano*, 154 Cal. App. 2d 732, 316 P.2d 717 (1957), holding that "sale" includes contract of sale or offer to sell.

<sup>6</sup> CAL. CORP. CODE § 25507.

where a definite plan has been formulated and no negotiation, as such, remains to take place; the definitive permit can be applied for directly. The large number of exempt securities may be found listed in sections 25100, 25102 and 25500 of the Corporations Code. Under section 25155 licensed brokers and designated financial and investment institutions may contract with a corporation for the sale of its securities without the corporation first having obtained a negotiating permit if certain other conditions are met; namely, the securities bought are for investment purposes only and that they will not, in turn, be resold to the public,<sup>7</sup> and that the agreement entered into states that "none of the proposed purchasers of the security is obligated to pay all or any portion of the purchase price of the security unless and until the company proposing to issue or sell the security has obtained from the commissioner a permit authorizing the issuance or sale of the security in accordance with the agreement."<sup>8</sup> Securities sold by the owner for his own benefit and account are exempt, provided the sale is not made, directly or indirectly, for the issuer or underwriter and is not sold with the intent to violate or evade any provision of the Corporate Securities Law.<sup>9</sup> Looking forward somewhat, it can also be stated that shareholder approval to corporate amendments which do not involve a change in the "rights, preferences, privileges or restrictions" that are merged in the securities may be solicited without the need of obtaining a negotiating permit. This is so because such solicitation does not constitute a "sale" under the Corporate Securities Law.<sup>10</sup> For example, an amendment changing the name of the corporation would not come within this definition<sup>11</sup> and, therefore, would not require the procuring of the permit for the solicitation of the shareholders. On the other hand, it has been held that the elimination of cumulative voting for directors is a change which comes within the definition of "sale" in section 25500 and hence makes obligatory the obtaining of a permit.<sup>12</sup>

Having listed the two excepted cases where the negotiating permit is not mandatory, we will consider now those situations where its use may be either convenient or necessary. A natural approach is to divide the field into pre-incorporation subscription agreements and post-incorporation dealings.

<sup>7</sup> CAL. CORP. CODE § 25155.

<sup>8</sup> *Ibid.*

<sup>9</sup> CAL. CORP. CODE § 25152.

<sup>10</sup> 10 CAL. ADM. CODE § 761.

<sup>11</sup> See H. B. Jones, *Common Operating Aspects of California Corporations*, ADVISING CALIFORNIA BUSINESS ENTERPRISES 641, 667 (Cont. Ed. Bar 1958).

<sup>12</sup> *Western Air Lines, Inc. v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961).

### *Pre-Incorporation Subscription Agreements*

Where a group of organizers wishes to form a corporation with a comprehensive agreement containing detailed information as to the corporate structure and their own individual rights, privileges and obligations, such an agreement will usually involve a stipulation as to the number and quality of shares to be received or bought by each organizer. Such a subscription agreement is not prohibited by the Corporate Securities Law, but such subscriptions are subject to certain conditions.<sup>13</sup> For example, any subscription taken prior to incorporation is conditioned upon the subsequent incorporation within 90 days after the agreement<sup>14</sup> and the definitive permit must, with reasonable diligence, be applied for and secured in accordance with the subscription agreement.<sup>15</sup> In addition, no consideration may be collected on account of the subscriptions taken prior to incorporation unless and until a permit for such collection is issued by the commissioner.<sup>16</sup> If it becomes necessary before incorporation to collect any of the consideration for the subscription, then a permit must be applied for and secured before such collection is allowed.<sup>17</sup> It must be understood that it is the individual organizers and not the proposed corporation who hold the property.<sup>18</sup> In addition, the consideration is held only in trust and is impounded as a protective measure for the benefit of the future shareholders.<sup>19</sup> One important restriction is not avoided by the issuance of a negotiating permit. That is that advertising concerning the prospective issuance of the corporate security is not permitted before the incorporation and issuance of the definitive permit without approval by the Commissioner of Corporations.<sup>20</sup>

### *Post-Incorporation Dealings*

The negotiating permit in post-incorporation dealings is used in two different transactions. The first is confined to issuance and sale of corporate securities, and a permit is required for negotiations involving them.<sup>21</sup> The second type of transaction includes solicitation

<sup>13</sup> CAL. CORP. CODE § 25153(a).

<sup>14</sup> CAL. CORP. CODE § 25153(a) (1).

<sup>15</sup> CAL. CORP. CODE § 25153(a) (2).

<sup>16</sup> CAL. CORP. CODE § 25153(b) (1).

<sup>17</sup> CAL. CORP. CODE § 25153. See 10 CAL. ADM. CODE §§ 393-402 (on impound regulations).

<sup>18</sup> *Ibid.*

<sup>19</sup> *Ibid.*

<sup>20</sup> CAL. CORP. CODE § 25604.

<sup>21</sup> CAL. CORP. CODE § 25516.

of security holders to consent to any change in the "rights, preferences, privileges or restrictions" which are a part of their outstanding securities<sup>22</sup> within the meaning of "sale" in section 25500 of the Corporations Code. This opens the door to control by the Commissioner over corporate amendments relating to shares, mergers, consolidations, reorganizations, recapitulations and reclassifications, all of which require approval by the corporate membership.<sup>23</sup> To obtain such approval the shareholders must necessarily be solicited. Hence, the negotiating permit is required before the shareholders' meeting takes place where the proposed changes in the corporate structure are to be proposed and approval solicited. As an example, one of the most frequent occurrences of an amendment of articles falling into this category is one which provides for a change in either the number or value of outstanding shares,<sup>24</sup> as occurs particularly in the instance of a stock split or reverse stock split, in neither of which is a right, preference, privilege or restriction changed without an alteration of the aggregate interest or stated capital.<sup>25</sup> This amending procedure can be accomplished in the following manner:<sup>26</sup>

1. A resolution should be passed by the board of directors authorizing amendment of the articles of incorporation to provide for the enlargement in the number of outstanding shares.<sup>27</sup>
2. A negotiating permit should then be obtained for the purpose of soliciting the approval of the majority of all outstanding shareholders in the usual manner.
3. After approval is obtained from the shareholders an *exchange permit* should be obtained from the Corporations Commissioner and a certificate of amendment filed with the Secretary of State.<sup>28</sup> Also, certified copies are required to be filed with the County Clerk of the county where the principal office of the corporation is located.<sup>29</sup>
4. The new share certificates are issued to the shareholders affected by the stock split. It is essential that all of the steps in the

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<sup>22</sup> CAL. CORP. CODE § 25009(a).

<sup>23</sup> CAL. CORP. CODE § 4107.

<sup>24</sup> CAL. CORP. CODE §§ 3634-35, 3638.

<sup>25</sup> CAL. CORP. CODE § 25500.

<sup>26</sup> JONES, *op. cit. supra* note 11, at 654-59.

<sup>27</sup> CAL. CORP. CODE § 3632.

<sup>28</sup> CAL. CORP. CODE § 3670. Forms may be found in CALIFORNIA CORPORATION MANUAL §§ 375-78 (Bancroft-Whitney 1961).

<sup>29</sup> CAL. CORP. CODE § 3674.

process of amendment be taken, for the shareholders can by appropriate action enjoin the corporation from acting on any amendment which was not legally adopted.<sup>30</sup>

Similar or slightly varying procedures involving the use of the negotiating permit may be found in proposed mergers, consolidations, reorganizations, recapitalizations and reclassifications; for in each case where a change would result in the rights, preferences, privileges or restrictions of the outstanding shares then the negotiating permit is required before soliciting shareholder approval. In the case of mergers there is a solicitation to exchange or sell the shares in the disappearing corporation for shares in the surviving one. So, instead of being considered as a "sale" because of a change in the shareholder's rights, it is considered an issuance of shares in the surviving corporation.

Where reorganizations are involved the negotiating permit comes into play if there is a statutory merger, or an exchange of stock for stock or stock for assets.<sup>31</sup> In the "statutory merger" the corporation which will survive should procure a negotiating permit before solicitation of proxies for the meeting of shareholders, required by section 4107 of the Corporations Code.<sup>32</sup> In the reorganization involving "stock for stock" the acquisition of the permit must come before the solicitation of consent from the shareholders of the corporation which will be acquired in the transaction. Where the reorganization involves "stock for assets" the negotiating permit should "normally be procured before the selling corporation solicits the consents or proxies of its shareholders for the purpose of complying with section 3901 of the Corporations Code."<sup>33</sup> All such plans of reorganization are subject to the Commissioner's approval before the definitive permit is issued. A public hearing to determine whether the plan of reorganization is fair may be held either at the request of the surviving corporation or upon the Commissioner's own motion.<sup>34</sup> This hearing can be held in connection with either the negotiating permit or the definitive permit.<sup>35</sup>

There are formal requirements of information which must accompany the application for a negotiating permit in the situations mentioned

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<sup>30</sup> *McDermont v. Anaheim Union Water Co.*, 124 Cal. 112, 56 Pac. 779 (1899).

<sup>31</sup> See Wheat, *Issuance of Securities Under the California Corporate Securities Law*, ADVISING CALIFORNIA BUSINESS ENTERPRISES 497, 509 (Cont. Ed. Bar 1958).

<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

<sup>34</sup> 10 CAL. ADM. CODE §§ 780-83.

<sup>35</sup> 10 CAL. ADM. CODE § 780.

previously. The application for the permit should state a clear and definite outline of the proposed plan. If shareholders are to be solicited then all documents used for this purpose are to be submitted. A copy of the deposit agreement, if any is to be used, together with a description of the securities held by persons proposed to be solicited must be tendered.<sup>36</sup> Furthermore, if the Commissioner deems it advisable, the applicant must furnish a verified list of the names and addresses of security holders to be solicited. Included in this should be a description of the nature and amount of the securities held by each.<sup>37</sup> Any application must list the reasons for the proposed merger, consolidation, reorganization, recapitalization or reclassification. This statement of reasons must be substantiated by a statement of the financial condition of the parties, their earning records and prospects for future earnings.<sup>38</sup>

### *Mechanics of Application for a Negotiating Permit*

The application for the negotiating permit will vary somewhat according to the use which is to be made of it, but there are standard requirements applicable to all applications. The applications must be in writing, on legal size paper written on one side only, and filed in accordance with all applicable provisions of sections 319-32 of the Administrative Code.<sup>39</sup> It must contain the names and identification of all parties concerned, their addresses, financial statements, and as complete a description of the proposed area of negotiation as is feasible.<sup>40</sup> Even in the case of pre-incorporation subscription agreements the information given must include the proposed name, proposed location, and the proposed articles of incorporation.<sup>41</sup> The application must also "be verified as provided in the Code of Civil Procedure for the verification of pleadings, and shall be filed in the office of the Commissioner."<sup>42</sup> In regard to an application for a permit to issue or sell securities after incorporation, section 320 of the Administrative Code and section 25502 of the Corporations Code enumerate all necessary information.<sup>43</sup> In general, it can be stated that the Commissioner requires complete identification of all parties and as complete a picture

<sup>36</sup> 10 CAL. ADM. CODE § 763.

<sup>37</sup> 10 CAL. ADM. CODE § 764.

<sup>38</sup> 10 CAL. ADM. CODE § 765.

<sup>39</sup> 10 CAL. ADM. CODE § 318.

<sup>40</sup> 10 CAL. ADM. CODE § 762.

<sup>41</sup> CAL. CORP. CODE § 25308.

<sup>42</sup> CAL. CORP. CODE § 25501.

<sup>43</sup> For a sample form for a negotiating permit to be issued for a merger, see CALIFORNIA CORPORATION MANUAL 473-76 (Bancroft-Whitney 1961).

of the proposed plan as is possible.<sup>44</sup> The fee for the negotiating permit is \$25.<sup>45</sup>

The issuance of the negotiating permit is left to the discretion of the Commissioner<sup>46</sup> upon his determination whether the proposed plan of negotiation is basically fair, just and equitable.<sup>47</sup> This can almost always be determined from the information contained in the application for a permit. If there is not enough such information to make the determination then supplementary information may also be requested by the Commissioner, and must be furnished by the applicant.<sup>48</sup> As a further aid in this determination, the Commissioner can, at his discretion, and will, at the request of the applicant, hold a public hearing.<sup>49</sup> The Commissioner also has authority to establish such rules and regulations as may be necessary to carry out the purposes and provisions of the Corporate Securities Law.<sup>50</sup>

All other code sections relating to issuance, denial, abandonment, suspension and revocation of permits are equally applicable to the negotiating permit.<sup>51</sup>

The Commissioner has the authority to impose conditions upon both the negotiating permit and the definitive permit to insure the protection of all parties.<sup>52</sup> One such condition is mandatory. Each permit must contain the following statement which is taken from Corp. Form A-6, issued by the office of the Commissioner of Corporations:

The Commissioner of Corporations of the State of California has made no finding or determination in relation to the fairness of the negotiation or agreements hereby permitted and this negotiating permit is permissive only and does not constitute a recommendation or endorsement of the securities permitted to be offered and should not be understood as an indication that such finding or determination of fairness will be made or that a definitive permit authorizing sale or issuance of securities, if applied for, will be granted.

The negotiating permit also contains three standard conditions which are imposed almost uniformly on all negotiating permits. They are

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<sup>44</sup> 10 CAL. ADM. CODE §§ 320, 763.

<sup>45</sup> CAL. CORP. CODE § 26002.

<sup>46</sup> 10 CAL. ADM. CODE §§ 300.2, 749; CAL. CORP. CODE § 25507.

<sup>47</sup> CAL. CORP. CODE § 25507.

<sup>48</sup> CAL. CORP. CODE § 25506.

<sup>49</sup> 10 CAL. ADM. CODE § 780.

<sup>50</sup> CAL. CORP. CODE § 25308.

<sup>51</sup> 10 CAL. ADM. CODE § 762.

<sup>52</sup> CAL. CORP. CODE § 25508.

stated on Corp. Form A-6a, also issued by the office of the Commissioner. They are:

1. That the applicant has no authority to receive any consideration unless and until a further permit authorizing this is granted.
2. That all agreements negotiated under this permit shall contain a condition to the effect that the applicant is not liable for failure to issue any securities unless and until the further permit authorizing such sale or issuance is granted. Also, that all agreements shall contain a true copy of the recitals hereinabove in this negotiating permit in bold face type set forth.
3. That unless revoked, suspended, or renewed, all authority to negotiate, or offer, or enter into agreements for the issuance of securities under this negotiating permit shall expire on the specified date.

### ***Conclusion***

It can be observed that the main function of the negotiating permit is to act as a control in the form of an authorization to proceed with business dealings which are somewhere between preliminary general discussions and firm and definite transactions or contracts. Just where the line can be drawn between the two is a moot question. The separation between preliminary discussions, which do not come under the Corporate Securities Law, and actual negotiations, which do, has not as yet been clearly defined by the Act or by the courts. It is because of this uncertainty that the procuring of the negotiating permit has become almost mandatory as a protective measure. When discussions involving corporate securities are to take place and some hope of actually entering into an agreement is entertained, then it is prudent to obtain the permit and insure that any subsequent transaction will be free from attack under the provisions of sections 25500 and 26100 of the Corporations Code.