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## STOCK OPTIONS UNDER CALIFORNIA CORPORATE SECURITIES LAW

By JOHN L. HENDRY\*

**I**N order to attract and retain top level executive personnel in an era of keen competition and large income taxes, modern business has found it necessary to supplement the ordinary salary compensation with other attractive inducements. Several available choices are profit-sharing, stock bonuses, deferred compensation, pensions, annuities, and stock options.<sup>1</sup>

Stock option plans have grown in popularity and are now used extensively. An obvious advantage in such a plan is to give the employee part ownership of the business with the expectation that it will increase his incentive and reduce the possibility of losing key employees to competing companies. For that reason option plans are ordinarily contingent on continued employment. An increasingly popular type of stock option, known as the "restricted stock option,"<sup>2</sup> has proved to be very satisfactory as a means of providing added compensation to the corporate employee. It is a device which complies with the Internal Revenue Code of 1954, section 421; *i.e.*, favorable tax treatment will be allowed if this section is complied with. In brief, the requirements are that:

1. The option must be granted for reasons connected with the employment by the employer corporation or its parent or subsidiary.
2. The option price must be at least 85% of the fair market value at the time the option is granted.
3. The option shall be exercisable only by the employee during his life (although it may be transferred by will, or exercised for the benefit of the employee's estate).
4. The optionee must not own stock possessing more than 10% of the total voting power.

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\* Member, Second Year class.

<sup>1</sup> See WASHINGTON AND ROTHSCHILD, *COMPENSATING THE CORPORATE EXECUTIVE* 18 (revised ed. 1951).

<sup>2</sup> See Schlesinger, *Selected Problems in the Use of Restricted Stock Options*, 36 *TAXES* 709 (1958).

5. The option must not be exercisable after the expiration of 10 years.
6. An optionee must not dispose of the securities within 2 years from the granting of the option nor within 6 months of the date of exercise.

When these restrictions are met, beneficial tax treatment may result to the employee. If the option price is at least 95% of the fair market value at the time the restricted option is granted, then on exercising the option only capital gain will be realized. If the option price is 85% to 95% of the stock's fair market value, then the difference between the option price and the market value on the date the options were granted or the option price and the market value on the date of disposition, whichever is lower, is subject to ordinary income taxation, the excess being capital gain.<sup>3</sup>

The California Corporations Code specifically authorizes the issuance of shares, option rights or securities which have conversion or option rights without a prior offering to other shareholders.<sup>4</sup> They may be issued in connection with other issues, or independently thereof.<sup>5</sup> The terms and conditions of any such option or conversion rights, not fixed by the articles of incorporation, shall be fixed by a resolution adopted by the board of directors.<sup>6</sup> As includible features, the option plan may contain the fixing of eligibility, the class and price of shares to be issued, the number of shares which may be subscribed for, the method of payment therefor, the effect of the termination of employment, restrictions on transfer, and the termination of the plan.<sup>7</sup> In Ballantine and Sterling, *California Corporations Laws*, it is said that the code provision allowing the granting of options by resolution of the board of directors in connection with other issues or independently thereof "is one of the most dangerous in the law."<sup>8</sup> The authors take the position that the privileges granted by the corporations code are subject to grave abuse:<sup>9</sup>

They may be utilized as a subtle contrivance by one or more directors, officers or bankers to keep a string on all future corporate growth, prosperity and increment in value without expense or risk or adequate

<sup>3</sup> *Id.* at 716.

<sup>4</sup> CAL. CORP. CODE § 1106.

<sup>5</sup> CAL. CORP. CODE § 1103.

<sup>6</sup> CAL. CORP. CODE § 1104.

<sup>7</sup> CAL. CORP. CODE § 1108.

<sup>8</sup> BALLANTINE & STERLING, *CALIFORNIA CORPORATION LAW* 138 (1949 ed.).

<sup>9</sup> *Id.* at 139.

consideration. When exercised at less than the value of the shares, they dilute the value of outstanding shares and transfer an interest in the surplus from the investors who took the risk to the option holders.

Under the California Corporate Securities Law<sup>10</sup> (subject to a few exceptions), a permit is required to offer for sale, negotiate for the sale of, or take subscriptions for any security.<sup>11</sup> Under California law an option is a security, and an option to buy is included in the definition of a sale: "A sale includes . . . an offer to sell; an attempt to sell; a solicitation of a sale; an option of sale; a contract of sale . . . ."<sup>12</sup>

The doubts expressed in *Ballantine* and *Sterling* have proved to be unfounded, for as mentioned above, an option to buy constitutes a sale of a security as defined by our code. For that reason a permit is required, and can be denied if the proposed issuance of securities is not fair, just, and equitable.<sup>13</sup> Also, the Commissioner of Corporations has extensive regulations in this area, as pointed out below.

### *Seasoned or Unseasoned*

Under the Commissioner's regulations, the amount of stock which can be set aside for stock options is determined by the classification of the company as being either "seasoned" or "unseasoned."<sup>14</sup> A seasoned company is one which has progressed beyond the initial financing stage. Options to purchase shares in excess of 10% of the outstanding common shares of a seasoned company will be considered with disfavor.<sup>15</sup> An unseasoned corporation is one still in the initial financing stage and options in excess of 20% will be looked on with disfavor.<sup>16</sup>

Other provisions, too, tend to eliminate the possibility of an issuance of securities which is unfair, unjust, or inequitable. The option may only be exercised within 5 years of its granting unless good cause for exception is shown.<sup>17</sup> This provision was apparently enacted to prevent any abuses which may arise over long term options, *i.e.*, where there is a risk that the market price of the stock will rise to such an extent that the option might be viewed as excessive or as a waste of corporate

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<sup>10</sup> CAL. CORP. CODE §§ 25000-26104.

<sup>11</sup> CAL. CORP. CODE § 25500.

<sup>12</sup> CAL. CORP. CODE § 25009. See *People v. Otterman*, 154 Cal. App. 2d 193, 316 P.2d 85 (1957); *Bourke v. Frisk*, 92 Cal. App. 2d 23, 206 P.2d 407 (1949); *People v. Boles*, 35 Cal. App. 2d 461, 95 P.2d 949 (1939).

<sup>13</sup> CAL. CORP. CODE § 25507.

<sup>14</sup> 10 CAL. ADM. CODE § 835.

<sup>15</sup> *Ibid.*

<sup>16</sup> *Ibid.*

<sup>17</sup> 10 CAL. ADM. CODE § 838.

assets.<sup>18</sup> It is to be noted that this 5 year restriction has not been applied to restricted stock options,<sup>19</sup> probably to attain uniformity with the federal law, and also because the 85% limitation should prevent unconscionable profits or other abuses.

Generally, pre-emptive rights exist and any new issues of securities must first be offered to the existing shareholders. But as mentioned above, under California law and in the absence of provisions in the articles of incorporation to the contrary, these preemptive rights have been abolished.<sup>20</sup> However, in the case of restricted stock options quasi-preemptive rights do exist in that the Commissioner has issued regulations requiring the submission of all such plans to shareholders for their approval.<sup>21</sup> This regulation was apparently enacted to protect the shareholders from dilution of their interests since the options will no doubt be offered at less than the fair market value. The Commissioner may also require that a written statement be sent to shareholders explaining the details of the option plan,<sup>22</sup> and if a possibility of substantial dilution of the outstanding shares exists, the Commissioner may require, as a condition precedent to the issue, that all outstanding shares be placed in escrow,<sup>23</sup> and that a public hearing be held if necessary for the public interest or protection of the shareholders.<sup>24</sup>

### *Options to Underwriters*

As in the case of employee stock options, using options to compensate the underwriter reduces cash outlay and gives the underwriter a stake in the corporation which provides incentive advantages.<sup>25</sup> Options to underwriters are subject to many of the same abuses that employee stock options are. It is for this reason that the Commissioner also has extensive regulations in this area. The value of the options must not exceed the selling expenses as prescribed by the Commissioner.<sup>26</sup> The same limitations on seasoned and unseasoned companies as were imposed on employee stock options are retained.<sup>27</sup> The options may not

<sup>18</sup> Small, *Compensating Corporate Executives*, ADVISING CALIFORNIA BUSINESS ENTERPRISES, 717, 730 (Cont. Ed. Bar 1958).

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

<sup>20</sup> CAL. CORP. CODE § 1106.

<sup>21</sup> 10 CAL. ADM. CODE § 831(d); BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 207-209 (4th ed. 1962).

<sup>22</sup> 10 CAL. ADM. CODE § 832.

<sup>23</sup> 10 CAL. ADM. CODE § 833.

<sup>24</sup> 10 CAL. ADM. CODE § 834.

<sup>25</sup> See ROBINSON, GOING PUBLIC—SUCCESSFUL SECURITIES UNDERWRITING 153 (1961).

<sup>26</sup> 10 CAL. ADM. CODE § 837.1(1).

<sup>27</sup> 10 CAL. ADM. CODE § 831.1(2).

be exercised after expiration of 5 years from the date of granting,<sup>28</sup> they must be at least 10% in excess of the public offering price during the first 24 months of the term of the options and at least 5% additional per annum.<sup>29</sup> Thus, in this area also, the Commissioner has broad discretionary powers to insure that the sale of the securities will be fair, just, and equitable.

### *The Out-of-State Issuer*

There can be no doubt that the Corporate Securities Law was intended to apply to foreign as well as domestic corporations. The word "company," as used in the code, includes all domestic and foreign private corporations, associations, syndicates, joint stock companies, and partnerships of every kind.<sup>30</sup> Although internal affairs of foreign corporations are not subject to California law, the sale of securities by a foreign corporation in California is subject to regulation under the Corporate Securities Law.<sup>31</sup> Subject to Constitutional limitations, a state has the power to regulate foreign corporations doing intrastate business.<sup>32</sup>

As previously mentioned, under California law an option is a security, and granting an option to buy is a sale of a security as defined by the code.<sup>33</sup> The definition of a sale is broad enough to include an agreement to reach an agreement to sell stocks.<sup>34</sup> In a leading case it was said:<sup>35</sup>

These provisions of the statute require a foreign corporation to secure a permit to solicit a sale of its stock in this state, or to engage in preliminary negotiations looking towards such sale, even though the issuance of the securities and the transfer of their title will, in good faith, be completed in a foreign state.

This case has been followed in subsequent decisions.<sup>36</sup> Thus a foreign corporation may be particularly vulnerable to the provisions of the

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<sup>28</sup> 10 CAL. ADM. CODE § 831.1(3).

<sup>29</sup> 10 CAL. ADM. CODE § 831.1(4).

<sup>30</sup> CAL. CORP. CODE § 25003. For general corporation provisions governing foreign corporations see CAL. CORP. CODE §§ 6200-04.

<sup>31</sup> *Western Air Lines v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961).

<sup>32</sup> *Wheeling Steel Corp. v. Glander*, 337 U.S. 562 (1949).

<sup>33</sup> CAL. CORP. CODE § 25509.

<sup>34</sup> *People v. Jacques*, 137 Cal. App. 2d 823, 291 P.2d 124 (1955).

<sup>35</sup> *B. C. Turf and Country Club v. Daugherty*, 94 Cal. App. 2d 320, 329, 210 P.2d 760, 765 (1949).

<sup>36</sup> *People v. Mills*, 148 Cal. App. 2d 392, 306 P.2d 1005 (1957); *People v. Sears*, 138 Cal. App. 2d 773, 292 P.2d 663 (1956); *People v. Whelpton*, 99 Cal. App. 2d 828, 222 P.2d 935 (1950).

Corporate Securities Law because of this broad definition of sale. The unwary corporation may find it is violating the act by granting stock options to California residents. In a recent decision<sup>37</sup> where the preliminary negotiations and the granting of options (not employee stock options) took place in California, and although the options to buy stock were exercised and the transfer took place outside California, the granting of the options was sufficient evidence of a sale of securities as defined by the Corporate Securities Law.

### *Why Require a Permit?*

The philosophy behind the Corporate Securities Law is "to prevent deception, the exploitation of ignorance, and all unfair dealings in the issue of securities."<sup>38</sup> In order to accomplish these aims the California law goes farther than the Blue-Sky laws of some other states. The earlier type of security regulation (no longer used by any states) was designed to protect against fraud. This type of law provided for penalties for the fraudulent sale of securities and for injunctive relief to protect the public from anticipated or further fraudulent acts.<sup>39</sup> The licensing of brokers or the registration of the securities was not provided for. Some other states now require only that the broker be licensed,<sup>40</sup> while others may require only that the security be registered.<sup>41</sup> California's law requires both the registration of the securities and the licensing of brokers.<sup>42</sup> The broad discretion given the Commissioner in determining what is fair, just, and equitable is deemed to be narrow enough to eliminate any hindrance to legitimate financing. The United States Supreme Court in construing Michigan's Blue-Sky law said, "It burdens honest business, it is true, but burdens it only that under its forms dishonest business may not be done."<sup>43</sup> The California Corporate Securities Law has been attacked in the state courts on the grounds that it is repugnant to the Fourteenth Amendment,<sup>44</sup> and also on the grounds that it is an undue burden on interstate commerce.<sup>45</sup> These contentions have been

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<sup>37</sup> *People v. Alison*, 189 Cal. App. 2d 201, 10 Cal. Rptr. 859 (1961).

<sup>38</sup> Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343, 348 (1945). See Pearce, *California Corporate Securities Law v. Proposed Uniform Securities Law*, 9 HASTINGS L. J. 1, 6 (1957).

<sup>39</sup> 1 BLUE SKY L. REP. ¶ 503.

<sup>40</sup> ME. REV. STAT. ch. 59, § 228.

<sup>41</sup> WYO. COMP. STAT. § 17-103.

<sup>42</sup> CAL. CORP. CODE §§ 25500, 25700.

<sup>43</sup> *Merrick v. N. W. Halsey Co.*, 242 U.S. 568, 587 (1916).

<sup>44</sup> *People v. Hoshor*, 92 Cal. App. 2d 250, 206 P.2d 882 (1949).

<sup>45</sup> *Auslen v. Thompson*, 38 Cal. App. 2d 204, 101 P.2d 136 (1940).

rejected under holdings that the California law is a valid exercise of the police power.<sup>46</sup>

Violation of the Corporate Securities Law can result in serious consequences. Foreign corporations must be cautious in issuing securities to California residents, since failure to comply with the provisions is a crime which may be punishable as a felony.<sup>47</sup> Any securities sold without a permit are void,<sup>48</sup> and the purchaser may have an action for damages,<sup>49</sup> or rescission.<sup>50</sup>

### ***Conclusion***

California's Corporate Securities Law is a standout example of paternalistic legislation. The basic philosophy of "let the seller beware" may work hardship in some cases, particularly in regard to foreign corporations, because of the broad definition given to the word, "sale." But the broad discretion given to the Commissioner in determining what is fair, just, and equitable has so far been deemed an expedient method of furthering the basic policy of the law, while still assuring that legitimate financing shall not unduly suffer.

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<sup>46</sup> *People v. Eiseman*, 78 Cal. App. 223, 248 Pac. 716 (1926).

<sup>47</sup> CAL. CORP. CODE §§ 26103-04. See *People v. Eiseman*, 69 Cal. App. 143, 230 Pac. 669 (1924).

<sup>48</sup> CAL. CORP. CODE § 26100.

<sup>49</sup> *Becker v. Stineman*, 115 Cal. App. 740, 2 P.2d 444 (1931).

<sup>50</sup> *Grove v. Barrett Co.*, 87 Cal. App. 165, 261 Pac. 739 (1927).