

1-1962

Securities Regulation: The Voting Switch Condition in a Permit to Issue Securities

Charles L. Gladson

Follow this and additional works at: https://repository.uchastings.edu/hastings_law_journal



Part of the [Law Commons](#)

Recommended Citation

Charles L. Gladson, *Securities Regulation: The Voting Switch Condition in a Permit to Issue Securities*, 14 HASTINGS L.J. 169 (1962).
Available at: https://repository.uchastings.edu/hastings_law_journal/vol14/iss2/7

This Comment is brought to you for free and open access by the Law Journals at UC Hastings Scholarship Repository. It has been accepted for inclusion in Hastings Law Journal by an authorized editor of UC Hastings Scholarship Repository.

SECURITIES REGULATION: THE VOTING SWITCH CONDITION IN A PERMIT TO ISSUE SECURITIES

By CHARLES L. GLADSON*

WHEN the Commissioner of Corporations of California issues a permit for the sale of securities,¹ he may impose a condition in the permit which provides:²

[T]he holders of the promotional securities as a group shall grant an irrevocable power of attorney or proxy to the holders of the other outstanding stock which shall entitle said holders as a group to elect a majority of the board of directors upon a default in payment of dividends (cash, property or stock) at the rate of five percent per annum on the selling price of such outstanding stock in an amount of two years' dividends at said rate.

This device, popularly termed "the voting switch condition," was added to the Commissioner's list of securities regulations in 1956, presumably under the authority granted to him by the Corporate Securities Act.³ Section 25508 of the act states in part: "The Commissioner may impose conditions . . . he deems reasonable and necessary or advisable for the protection of the public and the purchasers of the securities."⁴

Although this section delegates to the Commissioner a great deal of discretion,⁵ does it include within its broad purview the power to restrict the voting rights of corporate stockholders by administrative regulations such as the voting switch condition?

Application and Effect

The condition appears on its face to be a regulation devised by the Commissioner to subordinate the voting rights of the incorporators, who have been issued true promotional stock⁶ for little, if any, tangible

* Member, Third Year class.

¹ CAL. CORP. CODE § 25507.

² 10 CAL. ADM. CODE § 373.

³ CAL. CORP. CODE §§ 25500-26104.

⁴ CAL. CORP. CODE § 25508.

⁵ *The Uniform Securities Act, Final Report of the Assembly Interim Committee on Judiciary—Civil*, 23 INT. COMM. REP. No. 2., 7, 8.

⁶ Promotional stock is that issued at the outset to the original promoters of the corporation, who are defined in BALLANTINE, CORPORATIONS § 35, p. 101 (Rev. ed. 1946) as "those who undertake to form a corporation and procure for it rights . . . and capital by which to carry out the purposes set forth in the charter."

consideration, in order to protect the investing public against fraud, inefficient management or overly speculative securities. However, the Commissioner has gone much further than merely subordinating the voting rights of true promotional shareholders. A specific example would be the Commissioner's treatment of any stock purchased by close corporation insiders, for a monetary consideration lower than the consideration for which securities are to be subsequently sold to the public, as similar to promotional stock and thus subject to the voting switch condition.⁷ The burden this places upon the legitimate close corporation seeking a permit to issue stock to the public in order to finance corporate growth can be readily seen. The insiders, who own all of the presently outstanding capital stock of the corporation (paid for with cash at par value), must submit to the voting switch condition if the new offer is to be priced above par because the Commissioner can refuse to issue the permit without it.⁸ If, through depression, war, or act of God, the corporation is unable to meet its required dividend payments to the minority public stockholder group, then the insiders automatically lose their right, as majority stockholders, to vote for and elect the board of directors.⁹ As other methods of financing are often impractical or impossible, the voting switch condition must be accepted if a permit is to be obtained with the consequent risk of loss of voting rights.

Validity of the Condition

While there is no express limitation in the Corporate Securities Act on the conditions which may be imposed by the Commissioner,¹⁰ there is a judicial limitation on his power in this respect which was established in *Agnew v. Dougherty*.¹¹ The court held that the terms and conditions to be imposed in a permit must not be such as would create a greater burden than is consistent with safety and security. Whether the voting switch condition is such a burden as to exceed the

⁷ 10 CAL. ADM. CODE § 368: "Securities issued for services rendered, patents, copyrights or other intangible considerations, the value of which has not been established to the satisfaction of the Commissioner by means such as an established earning record, or which are issued for a monetary consideration substantially lower than the consideration for which securities are sold for principle financing purposes, ordinarily will be treated as promotion. The amount of promotion will be determined by facts and circumstances in each particular application."

⁸ CAL. CORP. CODE § 25500. See ADVISING CALIFORNIA BUSINESS ENTERPRISES §§ 7, 8, pp. 503, 504 (Cont. Ed. Bar 1958).

⁹ 10 CAL. ADM. CODE § 373.

¹⁰ *Otten v. Riesener Chocolate Co.*, 82 Cal. App. 83, 254 Pac. 942 (1927).

¹¹ 189 Cal. 446, 209 Pac. 34 (1922).

Commissioner's authority is open to speculation, for the courts have not as yet been called upon to rule on its validity. The courts have, however, held invalid conditions which appear to be very similar in substance and effect.

In *National Concentrator Co. v. Eccleston*¹² the Commissioner had imposed a condition in a permit requiring Eccleston, a prospective stockholder, to agree to waive his right to vote for and elect members of the board of directors, although he would hold an overwhelming majority of the stock in the corporation once the permit was issued and the stock purchased. The condition was imposed because the consideration given for the stock was a patent, of great but intangible value, thus treated by the Commissioner as if it were promotional stock.¹³ Eccleston complied with the condition, executed a voting waiver agreement and was not allowed to vote his shares at the next shareholders' meeting. The question presented involved the Commissioner's power to impose the condition. The court held that the condition was invalid and stated that the voting of stock was a valid, constitutional right of a stockholder and that the underlying reason for the imposition of conditions by the Corporations Commissioner was to safeguard the public against fraud in the issuance of stock, not to prohibit legitimate business or suppress the exercise by an individual of his constitutional rights. The court in *National Concentrator* reiterated the proposition laid down in the leading case of *In Re Dart*¹⁴ to the effect that the power of an administrator to pass reasonable regulation bears no relationship to the power to prohibit and suppress.

In *Film Producers Inc. v. Jordan*¹⁵ the right of a stockholder in California to vote for the board of directors was held to be fundamental, a point also made in *National Concentrator*. In *Mayberg v. Superior Court*¹⁶ it was held that the voting rights of shareholders in a corporation were an incident of property ownership and could not be interfered with; and in *Los Angeles v. Owens River Canal Co.*¹⁷ the denial of a stockholder's right to vote his stock was ruled grounds for an injunction restraining interference with this property right.

It appears from a review of *National Concentrator*, and the other cases just mentioned, that the right to vote stock, which is non-promo-

¹² 122 Cal. App. 698, 10 P.2d 1033 (1932).

¹³ 10 CAL. ADM. CODE § 368. See text accompanying note 7 *supra*.

¹⁴ 172 Cal. 47, 155 Pac. 63 (1916).

¹⁵ 171 Cal. 664, 154 Pac. 605 (1916).

¹⁶ 19 Cal. 2d 336, 341, 121 P.2d 688 (1942).

¹⁷ 120 Cal. App. 380, 7 P. 2d 1064 (1932).

tional in a true sense, is fundamental, and that it is not within the Commissioner's power to prohibit a stockholder's exercise of such right. It also appears that the Commissioner's interference with voting rights of a stockholder is beyond his power because it tends to prohibit legitimate business rather than to protect the public against fraud.

While *National Concentrator* has never been overruled by the California courts, it is arguable whether it is as authoritative today as when decided. It must be remembered that the decision was based *in part* on the theory that the rights of a stockholder to vote for the board of directors was a constitutional right. Subsequently, the applicable section of the Constitution of California¹⁸ was repealed in order to remove limitations on powers granted in other sections of the constitution, thus extinguishing the constitutional basis for the right to vote shares of stock. Shortly thereafter, however, the legislature enacted a slightly modified, though similar, version of the constitutional provision into the Corporations Code.¹⁹ The legislative guarantee was more flexible, providing that a stockholder would still have the right to vote his shares, subject to contrary provisions in the articles of incorporation or in a statute relating to the election of directors. Analyzing the code section, it seems that the voting right can now be taken away, but *only* by provisions in the articles of incorporation or by legislative enactment on stockholder voting rights.²⁰ It is to be noted that there is no California statute providing for administrative authority to deprive a majority stockholder of his right to vote at an election of members of the board of directors, nor does section 2215 of the Corporations Code provide that voting rights may be taken away by administrative action. Thus, it must follow that the rule in *National Concentrator* is still the law in California as to the validity of an administrative regulation depriving a stockholder of his right to vote, as does the voting switch condition when used.

¹⁸ CAL. CONST. art. XII, § 12: "In all elections for directors or managers of a corporation, every stockholder shall have the right to vote, in person or by proxy, the number of shares of stock owned by him, for as many persons as there are directors or managers to be elected . . . and such directors or managers shall not be elected in any other manner. . . ." (Italics added.)

¹⁹ CAL. CORP. CODE § 2215: "Subject to the provisions of sections 2218 to 2223, inclusive, only persons in whose names shares entitled to vote stand on the stock records of the corporation . . . are entitled to vote at the meeting. *In the absence of any contrary provision in the articles or in any statute relating to the election of the directors, each such person is entitled to one vote for each share.*" (Italics added.) Compare with language of CAL. CONST. art. VII, § 12 note 18 *supra*.

²⁰ See text of CAL. CORP. CODE § 2215 note 19 *supra*.

Another voting right safeguard is to be found in section 1100 of the Corporations Code which provides that: “. . . all shares of any one class or series of stock must have the same voting rights.” If only a portion of the authorized capital stock of the close corporation were to be purchased at par initially by insiders, it is entirely probable that the voting switch condition would be imposed by the Commissioner in an amended permit to issue the remaining authorized shares to the public at a price above par. As all of the outstanding shares will be of one class and series, the majority insider group would not have the same voting rights as the minority public group. Thus, apparently, there would be a violation of another code provision, substituted by the legislature for the repealed constitutional guarantee which was partly relied upon by the court in *National Concentrator*.

It may be argued that the condition in *National Concentrator* can be factually distinguished from the voting switch condition. The former condition simply required an agreement to waive the right of the stockholders to vote; but the voting switch condition requires an agreement giving an irrevocable proxy by the majority stockholders to the minority group.²¹ However, under careful scrutiny this difference appears to be one of form rather than substance; for in both cases a stockholder, or a group of stockholders, can be deprived of their rights to vote for the board of directors. In one case the stock simply can not be voted;²² in the other it can not be voted by the owner who otherwise has the right to vote it, *if* the condition is applied.²³ In both cases, we have an agreement waiving the voting right. In *National Concentrator* the court held that the agreement waiving the voting right did not forfeit the right because the agreement was compelled under a void order of the Commissioner. This rule seems equally applicable to the compelled agreement in the voting switch condition.

Enforceability of the Proxy Provision

An irrevocable proxy agreement is required of the majority stockholder group under terms of the condition. Some doubt can be raised as to the enforceability of this agreement in view of certain provisions of the Corporations Code. In California, unless a proxy is coupled with an interest, and unless such is stated on the face of the proxy, the proxy holder's power to vote is automatically revoked if the owner of the shares is present at the stockholders' meeting and elects to vote

²¹ 10 CAL. ADM. CODE § 373.

²² *National Concentrator v. Eccleston*, 122 Cal. App. 698, 10 P.2d 1033 (1932).

²³ 10 CAL. ADM. CODE § 373.

in person.²⁴ Also, under general principles of agency, the fact that the proxy reads on its face that it is irrevocable has no effect and can be revoked at will unless it is a power coupled with an interest.²⁵ An interest, within the meaning of this rule, is created when the proxy is given to secure creditors of the corporation, or as a basis for a change of a property right, or when joined with the power to sell the stock.²⁶ In the voting switch condition, the proxy is given under the compelled agreement, after the condition is executed, to the minority stockholders who are neither creditors of the corporation nor holders of any property right whatever in the stock owned by the majority stockholder group. Thus, there is clearly no proxy coupled with an interest within the meaning of the rule. Also, in California, a proxy is not valid after eleven months unless a longer period is specified.²⁷ In *Dougherty v. Cross*²⁸ the court held that even an agreement to give a proxy was invalid after eleven months where no longer period was specified. Applying these rules by analogy, it appears that the agreement to give an irrevocable proxy, which is required by the voting switch condition,²⁹ could be by-passed either by revocation of the proxy,³⁰ or expiration of the eleven month period,³¹ thus making the agreement unenforceable.

The underlying policy reason for the passage of the Corporate Securities Act was to protect the public against the perpetration of acts of fraud in the issuance and sale of securities.³² Its sole purpose was to disclose and uncover the acts of fraud, not to prohibit legitimate business or suppress the exercise by an individual of valid rights.³³ It is recognized that the Commissioner of Corporations must have some latitude in order to carry out his duties effectively. But, we have seen that the voting switch condition appears to operate outside of the provisions of section 2215 of the Corporations Code in that it takes away voting rights of stockholders through administrative regulation when

²⁴ CAL. CORP. CODE § 2228. See BALLANTINE, CORPORATIONS § 108, p. 263 (Rev. Ed. 1946); Comment, 36 Calif. L. Rev. 281 (1948); ADVISING CALIFORNIA BUSINESS ENTERPRISES § 6, p. 407 (Cont. Ed. Bar 1958).

²⁵ See annot. 159 A.L.R. 307 (1945); 3 WITKIN, SUMM. CAL. LAW, Corporations § 87, p. 2379 (1960).

²⁶ Annot. 159 A.L.R. 307, 308 (1945).

²⁷ CAL. CORP. CODE § 2226.

²⁸ 65 Cal. App. 2d 687, 151 P.2d 654 (1944).

²⁹ 10 CAL. ADM. CODE § 373.

³⁰ CAL. CORP. CODE § 2228. See annot. 159 A.L.R. 307 (1945).

³¹ CAL. CORP. CODE § 2226.

³² *In Re Hatch*, 10 Cal. 2d 147, 73 P.2d 885 (1937). See annot. 87 A.L.R. 42 (1933); annot. 163 A.L.R. 1051 (1946).

³³ *Dougherty v. Riley*, 1 Cal. 2d 298, 34 P.2d 1005 (1934).

the legislature has declared that such rights can only be taken away by statute or by the articles of incorporation. In 1932 an almost identical condition in a permit was held invalid in the *National Concentrator* case on the ground that it prohibited business and deprived the stockholder of his rights. In addition, the court in *Agnew v. Dougherty*³⁴ laid down a general guideline for the Commissioner, which, in effect, was not to create a greater burden on business by the exercise of his power than is necessary to protect the public.

Conclusion

While it appears upon analysis that the voting switch condition not only exceeds the *Agnew* limitation, but also conflicts with the voting rights sections of the Corporations Code³⁵ and the rule laid down in *National Concentrator*, nevertheless judicial decisions are not to be understood as having been formulated in a vacuum. Rather, they are developed to meet socio-economic requirements which vary from time to time. Thus, it is entirely possible that a liberal court will uphold the voting switch as a reasonable condition within the broad purview of section 25508 of the Corporations Code³⁶ and necessary to protect today's investing public in a more complex economic climate than existed at the time of the *National Concentrator* decision. Indeed, one recent California decision, *Western Airlines v. Sobieski*,³⁷ can be cited as an example of such a present liberal approach in this area. The lesson to be gained from this important decision is that the courts are now willing to go quite far in upholding expansion of the Commissioner's regulatory powers. However, if the voting switch condition is to be upheld, a liberal interpretation of the voting rights sections of the Corporations Code,³⁸ and an overruling of *National Concentrator* will first be required.

³⁴ 189 Cal. 446, 209 Pac. 34 (1922).

³⁵ CAL. CORP. CODE §§ 1100, 2215.

³⁶ This is the only limiting provision which section 25508 of the Corporations Code places on the Commissioner's power.

³⁷ 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961).

³⁸ CAL. CORP. CODE §§ 1100, 2215.