Welcome to California: Watch Out For Those Speed Bumps!

California has some quirky laws that often surprise lawyers from other states who are involved in California-based transactions. It is not always clear where some of our laws are going, or which direction a business person is meant to take.

To help you maneuver your way around these speed bumps, this series of articles explores some of the more unusual California laws that trip up or otherwise cause consternation to out-of-state attorneys involved in California transactions.

In previous months we looked at California usury laws and country club memberships that could be treated as a securities offering.

Get Your Mother to Invest in Your California Company --- Go to Jail! (Do Not Collect $200)

By Gerald Niesar and June Lin

Introduction

Imagine a start-up company trying to raise funds in California. As you would expect, the officers and directors of the company participate in the fundraising efforts as part of their duties. They are successful in selling stock and do not receive a commission for their participation in the sale of their company's securities. They are not licensed as broker-dealers. They haven't done anything illegal, right?

Wrong! At least according to a recent California criminal case which held that an officer or director who participated in the sale of securities for his or her company without a broker-dealer license, even with no transaction-based compensation, was a criminal.

People v. Cole [1]

According to the opinion in the 2007 case *People v. Cole*, an officer, founder, director or employee of an entity who participates in the sale of the entity's securities, and does not receive commissions or special compensation based upon sales of the securities, is a "broker-dealer" as defined in Section 25004 of the California Corporate Securities Law, and is in criminal violation of the law if he or she is not registered as a broker-dealer under Section 25210. Thus, any

[1] 156 Cal. App. 4th 452 (2007).

person who, as a regular part of his or her employment or other duties to an entity, assists in the sale of its securities without the assistance of a licensed broker-dealer, is a criminal and could face time in prison along with major fines.

The defendants in the *Cole* case claimed they were not selling securities in violation of licensing requirements because they were engaged in the selling activities on behalf of entities of which they were founders, officers and directors. Moreover, they were not receiving commissions or other transaction-based compensation in connection with the sales of the securities involved. They claimed they fit within the exclusion for "agents" in the definition of broker-dealer in Section 25004(a)(2), which provides that "broker-dealer does not include an agent, when an employee of an issuer." Section 25003 defines "agent" as "any individual, other than a broker-dealer or a partner of a licensed broker-dealer, who represents a broker-dealer or who for compensation represents an issuer in effecting or attempting to effect purchases or sales of securities in this state." However, Section 25003 goes on to say that an officer or director of the issuer is an agent only if he receives compensation specifically related to purchases or sales of the securities. The California appellate court rejected the defendants' argument that they were excluded from the definition of broker-dealer because they were corporate officers and directors who sold promissory notes in their own entities. The court held that the defendants did not fall within the exclusion for "agents" of an issuer because they did not receive commissions for the sale of the securities. The appellate court stated that allowing individuals to set up a corporation and sell securities without registration would conflict with the licensing statute's purpose of protecting investors.

Aftermath of *Cole* case

The *Cole* case creates a risk for all early stage California businesses, as well as businesses in other states which try to raise money in California. It is well known that virtually every early stage company must raise its capital without the assistance of a licensed broker-dealer. Therefore, if we believe *Cole* is good law, it follows that every officer, director, or other employee of such company who assists in that process is in violation of the licensing requirements of Section 25210, subjecting the person to criminal sanctions as exemplified in the *Cole* case. Furthermore, with the legislation that went into effect January 1, 2005, specifically Section 25501.5 of the Corporate Securities Law, unlicensed broker-dealers are unwittingly made "guarantors" of the success of the investment, no matter how complete and accurate the offering materials, and an argument may be made that the purchaser also has a rescission right against the issuer.

The *Cole* opinion unveiled a disconnect between practice, reality and law in California--not an unusual event. The problem in the *Cole* opinion was created by a literal reading of the law that was correct, but totally unintended by the legislature and not what the Department of Corporations believes the law to be or what the law has always been interpreted to be since its adoption in 1968.

Gerald Niesar, co-author of this article, brought this disconnect to the attention of the Department of Corporations by a letter to the Commissioner of Corporations in March 2008. In response, the Department issued a release in October 2008 to provide some clarity regarding broker-dealer licensing requirements for officers and directors of issuers who do not receive commissions from effecting securities transactions. The release stated that the *Cole* decision had limited impact and should not be read to stand for the proposition that an issuer's officers or directors must be licensed as broker-dealers unless they receive a commission for selling

securities. The release stated that an overly broad reading of *Cole* would create tremendous burdens on businesses without providing corresponding investor protection.

The release stated that an officer or director of an issuer could be excluded from the definition of broker-dealer if he or she does not "engage in the business" of effecting transactions in securities, defined in Commissioner's Opinion No. 98/1C as "business activity of a frequent or continuous nature." Thus, an officer or director could fall outside the definition of broker-dealer if the person effects securities transactions on a single or occasional basis.

The release went on to state that an officer or director of an issuer could be excluded from the definition of broker-dealer if he or she engages in the business of effecting securities transactions, if he or she does not receive a commission specific to effecting transactions in securities. However, this statement is contrary to the *Cole* court's literal reading of the law. Reading the definition of "broker-dealer" together with the definition of "agent" in the Corporate Securities Law leads to the conclusion that an issuer's officers and directors must be licensed as broker-dealers regardless of whether they receive a commission for selling securities.

Conclusion

The Department of Corporations' October 2008 release appears to confirm the generally held position that, consistent with federal broker-dealer regulations, officers and directors who help their companies sell securities in California but do not receive transaction-based compensation are generally exempt from California broker-dealer registration requirements. As a practical matter, California securities lawyers, including ourselves, follow the Commissioner's guidance in the October 2008 release. But the release does not resolve the uncertainty created by a literal reading of the Corporate Securities Law, as shown in the *Cole* opinion. According to the release, the Commissioner is considering the adoption of more formal regulations creating a safe

harbor for officers and directors who do not receive a commission for selling securities. Such a development would provide sorely needed clarity on this issue to businesses seeking to raise capital in California.

Copies of Gerald Niesar's letter to the Commissioner, the Commissioner's release, and other information relating to this subject matter may be found on our website http://www.nvlawllp.com.

This article is intended to provide a general summary and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. Gerald Niesar and June Lin are attorneys at Niesar & Vestal LLP in San Francisco, a law firm specializing in business law and corporate finance. For more information, please visit http://www.primerus.com/firms/niesar_whyte_vestal.htm or http://www.nvlawllp.com.