BUSINESS LAW SECTION

CORPORATIONS COMMITTEE
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REVISIONS TO UPDATE CALIFORNIA CORPORATIONS CODE REGARDING MERGERS (THE "50/90 RULE")

LEGISLATIVE PROPOSAL (BLS-2014-01)

TO: Office of Governmental Affairs

FROM: Philip Peters, Co-Chair, and Robert Rugani, Co-Chair, Corporations Committee (the "Committee"), Business Law Section (the "Section")

DATE: April 30, 2013

RE: Proposal to Amend Section 1101 of the California Corporations Code

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SECTION ACTION AND CONTACTS

Date of Approval by Section Executive Committee (the "Executive Committee"): July 12, 2013
Approval Vote:
For: 13 Against: 0

Executive Committee Contact:	Committee Contact:
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HISTORY, DIGEST, AND PURPOSE

The mission statement of the Committee provides that it shall study, consider, and take a position on and advocate that position with respect to, among other things, "Needed changes to the California Corporations Code" and "Other statutory changes that would promote efficiency or effectiveness in practice if made . . ." The Committee believes that certain changes to Section 1101 of the California Corporations Code (the "Code") are needed. Chapter 11 of the Code pertains to mergers, and Section 1101 sets forth the various items that are required to be stated in an agreement of merger, and discusses certain approval requirements. The Committee has concluded that it is consistent with its mission to propose to amend Section 1101 of the Code (i) to eliminate redundancy with respect to the definition of short-form mergers, (ii) to clarify that the additional shareholder approval requirements relating to certain types of merger transactions do not apply to arm's length transactions and (iii) to revise these additional shareholder approval requirements to require "a majority of the minority" approval rather than unanimous approval. These changes to Section 1101 would promote efficiency and effectiveness in practice by improving and modernizing relevant sections of the Code.

Background.

The last sentence of Section 1101 was added by amendments enacted in 1976 (Stats. 1976, ch. 641) to the new General Corporation Law that had been adopted in 1975, and which became effective on January 1, 1977 (Stats. 1975, ch. 682). Prior to these revisions, the Code did not contain language analogous to this provision, which was included for the purpose of restricting the cash-out of minority shareholders.

Existing Statute.

Section 1101 requires that the board of each corporation desiring to merge must approve an agreement of merger, which must state (a) the terms and conditions of the merger, (b) the amendments, if any, to the articles of the corporation surviving the merger, (c) the name and place of incorporation of each constituent corporation and which constituent corporation will be the surviving corporation in the merger, (d) the manner of converting the shares of each of the constituent corporations into shares or other securities of the surviving corporation (or if not converted into shares of the surviving corporation, the cash, rights, securities or other property those shareholders are to receive in the merger) and (e) any other details or provisions of the transaction that the board desires. In addition, Section 1101 requires that all shareholders of a class or series be treated equally with respect to any distribution of cash, rights, securities or other property in the merger. Finally, the last sentence of Section 1101 provides that, notwithstanding the fact that cash may be used as the consideration in the merger transaction, if the acquiring party is a controlling shareholder of the target corporation and the transaction is not a short-form merger, the nonredeemable common shares of the target corporation may be converted only into nonredeemable common shares of the surviving party, unless otherwise approved unanimously by all shareholders. This means that where an acquiring party owns more than 50%, but less than 90% of the shares of the target corporation prior to the merger, unanimous shareholder approval is required for the transaction to occur. The exact language reads as follows:

> Notwithstanding subdivision (d), except in a short-form merger, and in the merger of a corporation into its subsidiary in which it owns at least 90 percent of the outstanding shares of each class, the nonredeemable common shares or nonredeemable equity securities of a constituent corporation may be converted only into nonredeemable common shares of the surviving party or a parent party if a constituent corporation or its parent owns, directly or

> indirectly, prior to the merger shares of another constituent corporation representing more than 50 percent of the voting power of the other constituent corporation prior to the merger, unless all of the shareholders of the class consent and except as provided in Section 407.

This provision was "primarily intended to restrict the cash-out of minority public shareholders"[1] which was a major concern of the legislators at the time of its adoption. This provision was not intended to apply to a transaction with a third party acquirer in an arm's length transaction, as explained by Marsh: "…these provisions do not inhibit the use of the cash merger as a technique for making a cash acquisition of another corporation in an arm's length transaction."[2] When read on its face, however, this provision could be interpreted to apply in the context of a tender offer because the acquirer could own prior to the merger more than 50% but less than 90% of the target corporation as a result of its purchase of the target corporation shares in the tender offer. Because this reading is not consistent with the original intent of this provision, clarifications are needed to specify that the determination of ownership for purposes of the 50/90 test should be made prior to the execution of the merger agreement, not prior to the closing of the merger. Additionally, in the event of an all-cash acquisition by a controlling shareholder which is desirable to the majority of the minority shareholders, the Code should be further revised to allow for approval only by a majority of the minority shareholders, rather than by all such shareholders. A unanimous approval requirement is burdensome and gives a veto right to any single shareholder. Finally, Section 1101 should be further revised to reflect changes in the Code relating to short-form mergers which were made subsequent to its adoption.

Proposal.

The Committee proposes that Section 1101 of the Code should be revised as follows:

- The phrase "and in the merger of a corporation into its subsidiary in which it owns at least 90 percent of the outstanding shares of each class" in the last sentence of Section 1101 should be deleted.

- The determination of whether the acquiring corporation controlled the target corporation should be made immediately before the execution of the merger agreement, not prior to the merger.

- The unanimous shareholder approval requirement should be replaced with a requirement that a majority of the minority shareholders approve the transaction.

The proposed revisions would not affect the other requirements of the section.

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1 2 Harold Marsh, Jr., et al., MARSH'S CAL. CORP. L. §19.05 (4th Ed. 2010) ("Marsh"). The Committee would like to note that Harold Marsh, Jr. was the primary draftsman for the Committee at the time, and the members of that Committee worked with the California Assembly to make these revisions.

2 See Marsh.

Reasons for the Proposal.

The phrase "and in the merger of a corporation into its subsidiary in which it owns at least 90 percent of the outstanding shares of each class" in the last sentence of Section 1101 refers to "downstream" mergers and should be deleted to reflect changes in the Code relating to short-form mergers which were made subsequent to the adoption of Section 1101. Section 1110 of the Code governs short-form mergers and originally only provided for "upstream" mergers, whereby a subsidiary merged up into its Parent. In 1990, this section was amended to include the concept of "downstream" mergers, but Section 1101 was not amended to reflect this revision. Because a "downstream" merger is now included in the definition of a short-form merger, this language is repetitive and should be deleted as redundant.

The determination of whether the acquiring corporation controlled the target corporation should be made immediately before the execution of the merger agreement, not prior to the merger. This change is consistent with the approach previously taken by California courts on this issue. In *Steinberg v. Amplica, Inc.*, the California Supreme Court affirmed the holding of the Court of Appeals that for purposes of appraisal rights, the determination of whether an acquiring corporation controlled the target company should be made immediately before execution of the merger agreement, not immediately before the time of the shareholder vote or consummation of the merger. See 42 Cal. 3d 1198, 1214-1215 (1986). The same test should be applied in Section 1101 to ensure consistency in the Code.

Additionally, without this change, Section 1101 may be read to apply to tender offers by third party purchasers in arm's length transactions. This unintended reading would curtail the use of two-step mergers involving California public companies, which is the preferred structure for both targets and buyers due to its speed and efficiency. In a typical two-step merger, an acquiring corporation commences a cash tender offer to purchase all the outstanding shares of the target corporation. If the acquiring corporation purchases 90% or more of the target corporation's outstanding shares in the tender offer, then the acquiring corporation is able to consummate a short-form merger without further consent of the target corporation's shareholders. If the acquiring corporation purchases more than 50%, but less than 90%, of the target corporation's outstanding shares in the tender offer, then arguably the unanimous approval requirements of Section 1101 could be triggered because the acquiring corporation would own these shares prior to the merger. Obtaining unanimous approval in a public company context is virtually impossible, and thus this reading of Section 1101 would undermine the use of two-step mergers in California. In fact, the Committee has received anecdotal evidence from major law firms that because of the uncertainty surrounding the interpretation of this last sentence of Section 1101, one-step mergers are consistently recommended by counsel as the only viable alternative to public companies incorporated under California law. This is because a one-step merger avoids triggering the unanimous approval requirement due to the fact that the acquiring corporation would not own the shares until after the merger closes. One-step mergers are riskier and less appealing to both the acquiring corporation and the target corporation, and can take three to four months, while a two-step merger can be completed in as little as a month. One-step mergers also increase the time for shareholders to receive their merger consideration and increase the risk that the transaction may not be completed due to a failure to meet the conditions to close. Finally, one-step mergers require heightened SEC disclosure, which increases transaction costs for both parties. This result is unique to California and creates a competitive disadvantage for the State.

The unanimous approval requirement for all-cash acquisitions by a controlling shareholder is overly cautious and allows a single shareholder to hold a transaction hostage, even if an overwhelming number of minority shareholders favor it. Even if no shareholder actively opposes the acquisition, the transaction would fail if a single shareholder fails to consent. The Committee has received anecdotal evidence that mergers have been delayed for lengthy periods while the approval of all shareholders is sought. As such, amending the Code to require the approval of a majority of the minority shareholders would adequately protect the rights of the minority without being overly broad or cumbersome.

The ambiguity of Section 1101 and its burdensome unanimous consent requirement is unique to California and is frequently cited by practitioners as an impediment to transacting business as a California corporation. The 50/90 ownership requirements are viewed as "traps for the unwary," especially where a shareholder inadvertently or unwittingly becomes a holder of more than 50% of a corporation's stock. Some other reasons for the proposed revisions are listed below:

- Adequate minority shareholder protections already exist elsewhere in the Code and in case law, e.g. Dissenters' Rights (Chapter 13), the right for all shareholders to receive the same type and amount of consideration per share in a merger (penultimate sentence of Section 1101) and fiduciary duties to shareholders owed by the board and majority shareholders. Moreover, the proposed majority of the minority approval requirement would ensure that the minority shareholders will continue to have substantial control over the approval of the transaction.

- No other jurisdiction has adopted provisions similar to these portions of Section 1101, which puts California at a comparative disadvantage in attracting businesses to incorporate, and remain incorporated, in California.

- Nothing in the current statutory language of Section 1101 protects minority shareholders where a controlling shareholder owns more than 90% of the shares. Protection in those circumstances rests on case law requirements such as "entire fairness" or other judicial doctrines which would continue to protect all minority shareholders if Section 1101 is amended as proposed.

- The 90% ownership requirement concentrates power in the hands of a small minority of shareholders, creating disincentives to take corporate actions for the benefit of shareholders generally and, in some circumstances, permitting tyranny by the minority.

APPLICATION

If enacted, the proposed amendments to Section 1101 would become effective on January 1, 2015.

PENDING LITIGATION

As of the date submitted, the Committee is unaware of any pending litigation that is relevant to this legislative proposal.

LIKELY SUPPORT AND OPPOSITION

The Committee anticipates that the proposed revisions would receive the strong support of California corporations, venture capital investors, family owned businesses, and corporate law practitioners. Despite the continuing shareholder protections that would remain in place, some opposition from shareholder rights advocates is possible.

FISCAL IMPACT

No negative fiscal impact is expected. There may be a positive fiscal impact if more corporations incorporate in California or remain incorporated in California as a result of the proposed amendments.

GERMANENESS

The subject matter of the proposed revisions of Section 1101 is one in which the members of the Section (and, in particular, the members of the Committee) have special expertise because they are called upon to interpret provisions of the Code and provide guidance on California corporate and securities law matters. The subject matter requires the special knowledge, training, experience and technical expertise of the Section.

DISCLAIMER

This position is only that of the Corporations Committee of the Business Law Section of the State Bar of California. This position has not been adopted by the State Bar's Board of Trustees or overall membership, and is not to be construed as representing the position of the State Bar of California.

Membership in the Corporations Committee and in the Business Law Section is voluntary and funding for their activities, including all legislative activities, is obtained entirely from voluntary sources.

TEXT OF PROPOSAL

SECTION 1. Section 1101 of the Corporations Code is amended to read:

1101. The board of each corporation which desires to merge shall approve an agreement of merger. The constituent corporations shall be parties to the agreement of merger and other persons, including a parent party (Section 1200), may be parties to the agreement of merger. The agreement shall state all of the following:

(a) The terms and conditions of the merger.

(b) The amendments, subject to Sections 900 and 907, to the articles of the surviving corporation to be effected by the merger, if any. If any amendment changes the name of the surviving corporation the new name may be the same as or similar to the name of a disappearing domestic or foreign corporation, subject to subdivision (b) of Section 201.

(c) The name and place of incorporation of each constituent corporation and which of the constituent corporations is the surviving corporation.

(d) The manner of converting the shares of each of the constituent corporations into shares or other securities of the surviving corporation and, if any shares of any of the constituent corporations are not to be converted solely into shares or other securities of the surviving corporation, the cash, rights, securities, or other property which the holders of those shares are to receive in exchange for the shares, which cash, rights, securities, or other property may be in addition to or in lieu of shares or other securities of the surviving corporation, or that the shares are canceled without consideration.

(e) Other details or provisions as are desired, if any, including, without limitation, a provision for the payment of cash in lieu of fractional shares or for any other arrangement with respect thereto consistent with the provisions of Section 407.

Each share of the same class or series of any constituent corporation (other than the cancellation of shares held by a constituent corporation or its parent or a wholly owned subsidiary of either in another constituent corporation) shall, unless all shareholders of the class or series consent and except as provided in Section 407, be treated equally with respect to any distribution of cash, rights, securities, or other property. Notwithstanding subdivision (d), except in a short-form merger, ~~and in the merger of a corporation into its subsidiary in which it owns at least 90 percent of the outstanding shares of each class,~~ the nonredeemable common shares or nonredeemable equity securities of a constituent corporation may be converted only into nonredeemable common shares of the surviving party or a parent party if a constituent corporation or its parent owns, directly or indirectly, prior to the execution of the agreement of merger, shares of another constituent corporation representing more than 50 percent of the voting power of the other constituent corporation prior to the execution of the agreement of merger, unless ~~all of the shareholders of the class~~ consent is obtained from holders of at least a majority of outstanding shares of the class not held by the first constituent corporation or its parent and except as provided in Section 407.