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BUSINESS COMBINATIONS AND THE NEW GENERAL CORPORATION LAW

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I. FORMS OF CORPORATE COMBINATIONS

This article deals with the application of the new California General Corporation Law (GCL)[1] to transactions by which, broadly speaking, one corporation acquires another. Corporate acquisitions generally take one of two fundamental forms—a transfer of assets or a transfer of shares in exchange for some type of consideration. Each of these two forms of acquisition can be accomplished by a transaction involving either a transfer by operation of law (*i.e.*, a statutory merger or consolidation) or a transfer by conventional conveyance. A transfer by conveyance is customarily referred to as an acquisition of assets or an acquisition of shares, although in reality a statutory merger or consolidation also involves a transfer of assets or shares, albeit by statutory fiat. While an acquisition may involve the exchange of any form of value by one party for the assets or shares of the other, this article will focus primarily on those corporate fusions in which securities are the medium of exchange.

A *statutory merger* involves the fusion of one corporation, which automatically disappears, into another, which survives. As a part of this fusion there is an automatic transfer of all of the assets of the disappearing corporation to the surviving corporation and an assumption by the surviving corporation of all of the obligations of the disappearing corporation. The shares of the disappearing corporation are also automatically converted into shares or other securities of the surviving corporation or, in some cases, the shares or securities of a corpora-

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1. Law of Sept. 12, 1975, ch. 682, § 7, [1975] Cal. Stat. — [hereinafter cited as Gen'l Corp. Law and referred to as GCL]. This new General Corporation Law will take effect on January 1, 1977. The general corporation law in effect before January 1, 1977 is referred to as "prior law." Code section references in the text are to the GCL. Amendments have been made to the GCL prior to its effectiveness by A.B. 2849, recently enacted, Law of Aug. 27, 1976, ch. 641, [1976] Cal. Stat. — [hereinafter referred to as the Technical Amendments Bill]. To the extent that these amendments affect business combinations, they are reflected in this article.

tion controlling the surviving corporation. A *statutory consolidation* is similar to a merger in that a consolidation involves a statutory fusion of two corporations. However, the product of this fusion is not one of the combining parties, but a new corporation which is automatically created and succeeds to all of the assets and obligations of the consolidating corporations. The shareholders of the combining corporations generally become security holders of the newly created corporation.

In an *acquisition of assets* transaction, the acquiring corporation issues its shares in exchange for the assets of the acquired corporation and assumes the obligations of the acquired corporation. The transfer and assumption are accomplished by conventional instruments of conveyance and contract which permit the transfer and assumption of selected assets and obligations. This transaction is customarily followed by the winding up and dissolution of the acquired corporation, which includes the distribution of the shares received from the acquiring corporation to the acquired corporation's shareholders in cancellation of their shares in the acquired corporation. After the acquired corporation has disposed of all of its assets and its liabilities have been either discharged or provision for discharge has been made, the corporate existence of this entity is usually terminated.

An *acquisition of shares* transaction is accomplished by the acquiring corporation issuing its shares to shareholders of the corporation to be acquired in exchange for outstanding shares of the latter corporation. In a transfer of shares the acquired corporation will become a subsidiary of the acquiring corporation and ordinarily will not disappear. Shareholders of the acquired corporation become shareholders of the acquiring corporation. Since this type of transaction necessarily involves the assent of each transferring shareholder of the acquired corporation, an acquiring corporation cannot be assured of obtaining complete equity ownership of the acquired corporation unless all of the shareholders of the acquired corporation can be persuaded to accept the acquisition. This is in contrast with an acquisition of assets or a statutory merger or consolidation in which all of the shareholders of the acquired entity continue as security holders of the acquiring entity.

II. Prior Law

Apart from its Corporate Securities Law, California's corporation statutes historically have treated corporate acquisitions by establishing requirements for director and shareholder approval of certain of these

transactions[2] and by giving shareholders who dissent from a statutory merger or consolidation transaction dissenters' rights,[3] *i.e.*, they can cause their shares to be purchased for cash at an appraised value. A brief description of the application of these requirements under the prior law will serve as a useful framework to discuss the GCL.

Under prior law, statutory merger and consolidation transactions require the approval of the directors and shareholders of both the acquiring and acquired corporations.[4] Additionally, minority shareholders of either corporation who dissent from the transaction can cause their shares to be purchased for cash at an appraised value.[5]

In the case of a conventional acquisition of assets, prior law requires approval only by the directors and shareholders of the acquired corporation and the directors of the acquiring corporation.[6] No approval of the shareholders of the acquiring corporation is required.[7] Minority shareholders of the acquired corporation who dissent from the transaction are

2. CAL. CORP. CODE ANN. § 3901 (West 1955); *id.* §§ 4103, 4107 (West Supp. 1975).

3. *Id.* § 4300 (West Supp. 1975).

4. *Id.* §§ 4103, 4107.

5. *Id.* § 4300.

6. *Id.* § 3901 (West 1955). Prior law contains no specific requirement that the acquiring corporation's board approve an acquisition of assets. However, this formality is subsumed from the general requirements of prior law that the business and affairs of a corporation must be controlled by the board of directors. *See id.* § 800 (West Supp. 1975). Naturally, the board may delegate authority to the officers over the day-to-day operations of the corporation, but the authority to issue corporate securities for the assets, liabilities, and business of another company is of such importance that it is clear that a board must authorize such a transaction.

7. Some state courts have created the de facto merger doctrine in order to apply the statutory formalities of mergers to acquisition of assets transactions that are in substance and effect similar to statutory mergers. *See, e.g.*, Applestein v. United Bd. & Carton Corp., 159 A.2d 146 (N.J. Super. Ct.), *aff'd per curiam*, 161 A.2d 474 (N.J. 1960); Farris v. Glen Alden Corp., 143 A.2d 25 (Pa. 1958). *But cf.* Heilbrunn v. Sun Chem. Corp., 150 A.2d 755 (Del. 1959). In *Farris v. Glen Alden Corp.*, the court enjoined the acquiring corporation from consummating a purchase of assets because the transaction was in substance a merger that was not being accomplished in accordance with the statute, which included a requirement of approval by the shareholders of the acquiring corporation. In that case the business of the purchasing corporation would have undergone a radical change, the book value of each of its shares would have been reduced from $38 to $21, and control would have been shifted to the stockholders of the acquired company. In *Applestein v. United Bd. & Carton Corp.*, the shares to be issued by the acquiring corporation would have transferred control of that company to the sole stockholder of the corporation to be acquired and the book value of each share of the acquiring company would have been reduced from $32 to $23. The court held that approval by the stockholders of the acquiring corporations was necessary to a valid acquisition. Although there is no California decision applying the de facto merger doctrine, Justice Traynor referred to it and cited *Farris* with approval in Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 117, 460 P.2d 464, 477-78, 81 Cal. Rptr. 592, 605-06 (1969).

not given dissenters' rights and are, in effect, compelled to accept the securities of the acquiring corporation in exchange for their interests in the acquired corporation.[8]

Prior law contains no express requirements for a conventional acquisition of shares. However, it is clear that this type of transaction ordinarily would require the approval of the directors but not the shareholders of the acquiring corporation.[9] Since the acquired corporation is not a formal party in this type of acquisition, there is no requirement that the directors of this corporation approve the transaction. Additionally, there is no need for a formal vote of the shareholders of the acquired corporation because a conventional acquisition of shares implicitly involves the assent of each exchanging shareholder. Minority shareholders who dissent from this type of acquisition retain their shares in the acquired corporation and are not given dissenters' rights.

The application of these requirements can be illustrated by the following examples which involve a combination of *B*, a large company, and *S*, a company whose assets, sales, and earnings equal less than ten percent of *B*'s.

Example One. *B* can accomplish an acquisition of *S* without a vote of *B*'s shareholders by a conventional acquisition of the assets or shares of *S*. *S*'s shareholders will have to approve the transaction.

Example Two. The same result as in *Example One* can be accomplished without a vote of *S*'s shareholders if *S* has sufficient authorized and unissued shares. In such a case the roles are reversed and *S* acquires the assets or shares of *B*. In this classic "gnat swallowing the camel" transaction, *S*'s shareholders will suffer substantial dilution of voting power such that control of *S* will shift to the shareholders of *B*. While *B*'s shareholders will have a vote on whether to "sell out" to *S*, *S*'s shareholders will not have to approve the transaction. Additionally, notwithstanding the significant impact of the transaction on *S*'s shareholders, they will not have dissenters' rights.

Example Three. If *B* and *S* merge or consolidate, the shareholders of both companies would have to vote on the transaction, and dissenting

8. The de facto merger concept should be equally applicable to protect the interests of the shareholders of the acquired corporation. However, in Delaware the doctrine fares no better for the attacking shareholders of the selling corporation. *See* Hariton v. Arco Elect., Inc., 188 A.2d 123 (Del. 1963).

9. This requirement would stem from the same provisions which impose a requirement of board action to authorize an acquisition of assets. *See* note 6 *supra*.

minority shareholders of both companies would have dissenters' rights. Even though the impact of the transaction on *B*'s shareholders is minimal, *B* must call a shareholders' meeting, solicit proxies, and subject itself to dissenters' rights demands in order to effect even a very small acquisition.

Example Four. If the *Example Three* transaction is rearranged so that *S* merges into a wholly-owned subsidiary of *B*, the shareholders of *B* will not have to vote on the acquisition or be given dissenters' rights.

Example Five. Conversely, if *B* were to merge into a wholly-owned subsidiary of *S*, *S*'s shareholders would not have to vote on the transaction or be given dissenters' rights, in spite of the significant impact of the acquisition on *S* and its shareholders.

The above examples demonstrate that anomalies are created by the prior law's preoccupation with the form of a business combination. The protective mechanism of shareholder approval and dissenters' rights are often withheld when the circumstances clearly compel a contrary result, as in the case of the shareholders of *S* in *Examples Two* and *Five.* Additionally, these mechanisms are sometimes applied when the interests being protected are not significant enough to warrant the delay, expense, and complication incident to those rights, as in the case of *B* in *Example Three.* In some cases, shareholder approval is available but dissenters' rights are denied when there is no persuasive rationale for making this distinction. In this respect, compare the position of the shareholders of *S* in *Example One* if an acquisition of assets is employed, with that of the same shareholder group in *Example Three.* In both of these examples the effect on *S*'s shareholders is identical. They will suffer substantial dilution in voting power and will receive shares of a totally different enterprise.

In summary, prior law distinguishes between a protectible shareholder interest and one that does not require protection by focusing upon whether the shareholder's corporation is being acquired or is doing the acquiring. In the latter case, the interest is protected only if a statutory merger or consolidation is used. Although in the former case the interest will be protected to some degree by requiring shareholder approval, the more complete protection afforded by dissenters' rights will be withheld unless the form of the combination is a merger or consolidation. And in neither case will the prior law attempt to determine whether protection should be required by measuring the impact of the transaction on the affected shareholder groups.

III. The New General Corporation Law

A. Introduction

The general theoretical treatment of business combinations under the GCL is in one important respect similar to the prior law and in another respect it represents a significant departure from prior law. The principal similarity is that, with minor exceptions, neither prior law nor the GCL attempts to impose any quantitative or qualitative requirements of substantive fairness for acquisitions.[10] Both statutory schemes define shareholder interests that deserve protection and then establish mechanisms to protect these interests. These mechanisms are director and shareholder approval and dissenters' rights.

The principal theoretical difference between the GCL and prior law is that the GCL is generally more consistent both in its selection of shareholder interests that deserve protection and in its application of the mechanisms to accomplish that protection. One example will illustrate this point. Under prior law, the shareholders of an acquiring corporation are not required to vote on an acquisition unless the form of the acquisition is a statutory merger or consolidation.[11] As noted earlier, there is no logical basis for limiting the shareholder approval requirement to a merger or consolidation because the potential impact of an acquisition on the acquiring corporation's shareholders will not vary with the form of the transaction. The GCL recognizes that whether the interests of an affected shareholder group should be protected and what type of protective mechanisms should be available should depend on the need for protection rather than the form of the acquisition transaction or the status of the affected shareholders' corporation as the acquired or the acquiring corporation.

In defining the shareholder interests that are entitled to protection, the GCL begins with the general proposition that all business combinations should be approved by the board of directors and shareholders of

10. One of the exceptions to this generality is the GCL requirement that in a merger reorganization each of the shares of the same class of stock of each constituent corporation must be treated equally in terms of the cash, property, rights, or securities issued in exchange for these shares. Gen'l Corp. Law, *supra* note 1, § 1101. In addition, in a merger reorganization in which one constituent corporation owns more than fifty percent of another constituent corporation, the GCL limits the type of consideration that may be given for the non-redeemable common shares of the acquired corporation to non-redeemable common shares of the surviving corporation or a parent corporation. *Id.* *See* text accompanying notes 105-14 *infra.*

11. Cal. Corp. Code Ann. §§ 3900, 4107 (West 1955).

each of the corporate parties.[12] The shareholders of each party are thus protected both by their own judgment and the judgment of the board of directors of their corporation. The GCL recognizes, however, that it should not be necessary to have a corporation's shareholders pass on a combination if the impact of that transaction on their interests would not be significant. In such a case the shareholders' interests can be protected by the judgment of the board of directors.[13]

In measuring the impact of a combination on a shareholder group, the GCL focuses on the voting power these shareholders will be entitled to exercise immediately after the transaction is completed. If after the combination the shareholders of a party will own equity securities representing *more* than five-sixths of the voting power of the continuing corporate enterprise, the impact of the transaction on these shareholders is viewed as being insignificant and they are not required to vote on the combination.[14] Conversely, if the voting power of their equity securities will be five-sixths or less, the impact is treated as significant. Shareholders will also be entitled to protection against a modification of their shareholder rights in a combination even if the impact of the transaction on their voting power would not be viewed as significant.[15]

The GCL is also more consistent than prior law in employing the protective mechanism of dissenters' rights. In any case where the impact of a combination on the shareholders of a corporate party is viewed as significant, *i.e.*, where they are given the right to vote on the transaction, dissenters' rights will be accorded to the shareholders of that corporation.[16] Dissenters' rights are also given to the minority shareholders of the subsidiary in a short-form merger, although they are not given the right to vote on the transaction.[17]

B. "Reorganization" and Other GCL Terminology

Before examining and analyzing the new legal requirements for business combinations, a brief review of GCL terminology is necessary.

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12. Gen'l Corp. Law, *supra* note 1, §§ 1200, 1201(a); *see* text accompanying notes 35-49 *infra*.

13. Gen'l Corp. Law, *supra* note 1, § 1201.

14. *Id.* § 1201(b); *see* text accompanying notes 48-61 *infra*.

15 Gen'l Corp. Law, *supra* note 1, §§ 1201(c)-(e); *see* text accompanying notes 62-67 *infra*.

16. Gen'l Corp. Law, *supra* note 1, § 1300(a); *see* text accompanying notes 185-90 *infra*.

17. Gen'l Corp. Law, *supra* note 1, § 1300(a).

Like prior law, the GCL authorizes business combinations to be effected by operation of law as well as by conventional conveyance. However, the operation of law combinations permitted by the GCL are limited to the regular statutory merger and the so-called "short-form" merger. The statutory consolidation has been eliminated from the acquisition statutory scheme because it was seldom used and even less frequently needed. The GCL refers to a regular statutory merger as a *merger reorganization*;[18] to an acquisition of shares for equity securities as an *exchange reorganization*;[19] and to an acquisition of assets for equity or debt securities as a *sale-of-assets reorganization*.[20] The term "reorganization" is derived from the Internal Revenue Code, and the three types of reorganizations authorized by the GCL roughly correspond to the type A, B and C reorganizations under that Code.[21]

Section 181 of the GCL defines the three types of *reorganization*. A *merger reorganization* is a statutory merger other than a short-form merger.[22] In general, the medium of exchange in a statutory merger may be shares or debt securities, cash, or other property.[23] A party to a merger reorganization is referred to as a *constituent corporation*.[24] The *surviving corporation* is the constituent corporation into which the other constituent corporation or corporations are merged,[25] the latter corporations being termed *disappearing corporations*.[26]

A *short-form merger* is a statutory merger of a subsidiary into a parent corporation where the parent owns at least 90 percent of each class of the outstanding shares of the subsidiary.[27] No vote of the shareholders of the parent or subsidiary corporations is required to accomplish a short-form merger, but the minority shareholders of the subsidiary are given dissenters' rights.[28]

An *exchange reorganization* is an acquisition of the shares of one corporation in whole or in part in exchange for equity securities of either the acquiring corporation or a corporation that has control of the acquiring corporation, where immediately after the acquisition the ac-

18. *Id.* § 181(a).
19. *Id.* § 181(b).
20. *Id.* § 181(c).
21. INT. REV. CODE OF 1954, §§ 368(a)(1)(A)-(C).
22. Gen'l Corp. Law, *supra* note 1, § 181(a).
23. *Id.* § 1101(d); *see* text accompanying notes 96-101 *infra.*
24. Gen'l Corp. Law, *supra* note 1, § 161.
25. *Id.* § 190.
26. *Id.* § 165.
27. *Id.* §§ 187, 1110; *see* text accompanying notes 147-81 *infra.*
28. Gen'l Corp. Law, *supra* note 1,§§ 1110, 1300(a).

quiring corporation controls the acquired corporation.[29] The term *equity security* means any share or security convertible into a share (whether or not additional consideration must be given) or any warrant or right to purchase a share or convertible security.[30] *Control* is defined for purposes of sections 181, 1001 and 1200 as the direct or indirect ownership of shares possessing more than 50 percent of the voting power of the controlled party.[31] Otherwise, *control* means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a corporation.[32]

Voting power is defined as the power to vote for the election of directors but excludes the right to vote upon the happening of a condition or event which has not yet occurred.[33]

The definition of a *sale-of-assets reorganization* is the acquisition by one corporation of all or substantially all of the assets of another corporation, in exchange in whole or in part for either or both of the following types of consideration: (a) equity securities of the acquiring corporation or of a corporation which is in control of the acquiring corporation, or (b) debt securities of either of these corporations if the debt securities both have a maturity date more than five years from the consummation of the reorganization and are not adequately secured.[34]

C. *The Shareholder Approval Requirement*

1. The Requirement and the Required Vote

Section 1200 of the GCL requires that a reorganization be approved by the board of directors of:

(a) Each constituent corporation in a merger reorganization;

(b) The acquiring corporation in an exchange reorganization;

(c) The acquiring corporation and the corporation whose property and assets are being acquired in a sale-of-assets reorganization; and

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29. *Id.* § 181(b).

30. *Id.* § 168.

31. *Id.* § 160(b).

32. *Id.* § 160(a). The origin of this definition is rule 405 of the Securities and Exchange Commission, 17 C.F.R. 230.405(f) (1975) promulgated pursuant to the Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (1970).

33. Gen'l Corp. Law, *supra* note 1, § 194.5. If different classes of shares are entitled to vote as separate classes of shares for different members of the board, the determination of percentage of voting power is made on the basis of the percentage of the total number of authorized directors which the shares in question have the power to elect in an election at which all shares then entitled to vote for the election of directors are voted. *Id.*

34. Gen'l Corp. Law, *supra* note 1, § 181(c).

> (d) The corporation in control of any constituent [corporation in a merger reorganization] or [of any] acquiring corporation . . . [in an exchange or sale-of-assets reorganization] and whose equity securities are issued or transferred in the reorganization. . . .[35]

The control corporation in subsection (d) is referred to in the GCL as a *parent party*. Section 1201(a) provides that "the principal terms of a reorganization shall be approved by the outstanding shares of each class of each corporation the approval of whose board is required. . . ."[36] The effect of this section is to require the approval of a business combination by the shareholders of the entity whose equity securities are being issued, as well as by the shareholders who will be receiving these securities in exchange for their shareholdings in another party to the reorganization. The shareholder approval requirement with respect to a corporate party is subject to an important exception discussed below for reorganizations that do not have a significant impact on the voting power of the shareholders of that party.

Prior law requires one shareholder vote to approve a merger or consolidation and another vote to approve sale-of-assets transaction. In the former case the transaction must be approved by the holders of two-thirds of the shares of each class of a company,[37] while a sale-of-assets need only be approved by a vote of the holders of shares representing a majority of the voting power.[38] The GCL generally establishes a single shareholder vote for all forms of reorganization. Section 1201(a) provides that a reorganization must be "approved by the outstanding shares . . . of each class" of each corporation whose shareholders must approve the reorganization.[39] The phrase "approved by the outstanding shares" is defined in section 152 to mean the affirmative vote of a majority of the outstanding shares of each class or series entitled to vote on reorganizations, either by a provision in the articles or by the GCL. If a corporation's articles require a higher percentage vote of any class or series for approval of a reorganization, the reorganization must be approved by this "super majority."[40] Section 117 requires that the vote

35. *Id.* § 1200.

36. *Id.* § 1201(a).

37. CAL. CORP. CODE ANN. § 4107 (West Supp. 1975).

38. CAL. CORP. CODE ANN. § 3901 (West 1955).

39. Gen'l Corp. Law, *supra* note 1, § 1201(a). Delaware law generally requires a majority vote of the outstanding stock entitled to vote to approve a merger, consolidation, or sale-of-assets, but in the case of a sale-of-assets the shareholder approval requirement applies only to the selling corporation. DEL. CODE ANN. tit. 8, §§ 251(c), 271(a) (1974).

40. Gen'l Corp. Law, *supra* note 1, § 152. The articles of a corporation may provide

required by section 1201(a) be of each outstanding class of shares irrespective of limitations or restrictions on voting rights.

Establishing a single shareholder approval requirement for all forms of combination is an extension of the policy underlying the GCL that the availability and application of protective mechanisms should depend on the substance of the transaction. The GCL's selection of a majority class vote appears to be something of a compromise between the prior law's requirement for a two-thirds class vote for mergers and consolidations and a majority non-class vote for sale-of-assets transactions. The wisdom of adopting a majority rather than a two-thirds vote can of course be debated, but it is impossible to prove that one is more logical or beneficial than the other.

Proponents of a majority voting requirement contend that a two-thirds voting requirement enables a small minority to dictate the affairs of persons with almost twice their holdings. The criticism aimed at the majority voting requirement is that it does not afford adequate protection to a large minority. This criticism of the majority vote in large part should be obviated by the GCL's requirement that shareholders objecting to the action of the majority will be entitled to dissenters' rights. Furthermore, for financial, tax, and accounting reasons very few reorganizations will in fact be consummated if a sizable minority exercises these rights.[41]

There are two exceptions to the provision that shares are entitled to vote as a class or series irrespective of limitations on voting rights. First, two classes of common shares that differ only as to voting rights will be treated as a single class.[42] The rationale for this appears to be that neither class is viewed as having an interest requiring special protection because the required approval must include the vote of shares without regard to limitations on voting rights.[43] The logic of this rationale is questionable since it disregards the dilutive effect of a reorganization in which voting securities will be issued on the voting power of voting common shares. This power, which by hypothesis is unique to the

for the vote of all of the shares of any class or series, or of a larger proportion than is required by section 1201(a). *Id.* § 204(a)(5). If the articles of a corporation grant voting rights to holders of securities other than shares, *see id.* § 204(a)(7), all references in the GCL to the voting of shares includes the voting of these securities. *Id.* § 111.

41. See notes 224, 310-25 *infra* and accompanying text.

42. Gen'l Corp. Law, *supra* note 1, § 1201(a).

43. REPORT OF THE ASSEMBLY SELECT COMMITTEE ON THE REVISION OF THE CORPORATIONS CODE 94 (1975); [hereinafter cited as ASSEMBLY REPORT].

voting shares, is surely an interest deserving of special protection vis-à-vis nonvoting common shares. It would have been more logical to require a class vote by the voting common as well as an affirmative vote by the holders of both classes of common treated as a single class.[44]

The second exception to the general rule that shares are entitled to vote as a class relates to preferred shares. No approval is required of any class of preferred shares of the surviving or acquiring corporation or any parent party "if the rights, preferences, privileges and restrictions granted to or imposed upon such class of shares remain unchanged . . . ."[45] This exception is subject to two qualifications. It does not apply if voting rights are granted to preferred shares in the articles.[46] Further, it has no application in a merger reorganization if the merger agreement amends the articles under circumstances that would require approval of the holders of the preferred shares.[47]

The apparent purpose of the preferred share exception was to prevent the holders of a relatively small class of shares from blocking a reorganization unless their special demands were met. Nevertheless, this is a troublesome provision. It permits a reorganization to dilute or modify the economic position of outstanding preferred shares without any approval of the holders of these shares. For example, the issuance of another series of preferred shares that are senior on liquidation to outstanding preferred shares does not, strictly speaking, change the liquidation preferences of these outstanding shares. However, the creation of interests with a superior claim on the corporation's assets obviously affects the economic position of these shares.[48]

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44. Perhaps the true rationale for requiring common shares to vote as a single class is that it is highly unlikely that nonvoting common shares will be issued in view of the strong policy of the California Commissioner of Corporations that common shares carry voting rights. *See* CAL. ADM. CODE § 260.140.1. In those few instances when nonvoting common stock is issued it will be held by very few persons. If a class vote of these shares were required, the few holders of these shares would therefore be able to block a reorganization.

45. Gen'l Corp. Law, *supra* note 1, § 1201(a).

46. *Id.*

47. *Id.* § 1201(c).

48. This example, of course, assumes that the corporation's articles authorize the issuance of senior preferred shares. If an amendment to the articles would be required for this issuance, the GCL would require a class vote of the outstanding preferred before preferred shares with superior rights could be authorized. *Id.* § 903(a)(5). Even if the corporation would not require an amendment to its articles to accomplish this, the terms of the outstanding preferred shares, if carefully drafted, would often require a class vote as a protective device. Additionally, if the issuance of the senior preferred would require qualification under the California Corporate Securities Law of 1968, CAL. CORP. CODE ANN. §§ 25000-804 (West Supp. 1975), the California Commissioner of Corpo-

Another instance of a possibly significant impact on outstanding preferred shares would be the issuance of common shares which would dilute the conversion privilege of preferred shares.[49] Denying preferred shares the right to vote on a reorganization is inconsistent with the GCL's general theory of affording protection to shareholder interests that may be significantly and adversely affected by a reorganization. This exception also does not square with granting nonvoting common shares the right to vote on a reorganization. There is no rational basis for giving special protection to the interest of a nonvoting common shareholder but denying this right to a nonvoting preferred shareholder.

Another problem with the preferred share exception is that it applies only to outstanding preferred shares of the surviving corporation, the acquiring corporation, or a parent party. The outstanding nonvoting preferred shares of the acquired corporation in a sale-of-assets reorganization and of the disappearing corporation in a merger reorganization are given a class vote on the reorganization. Thus, the GCL distinguishes between a shareholder interest that is deserving of protection and one that is not on the basis of whether the interest is in the acquired or the acquiring corporation. This is an artificial distinction which can lead to business combinations being structured so as to avoid a vote of preferred shareholders when their interests are significantly and adversely affected.

2. The Voting Power Dilution Exception to Shareholder Approval

The GCL does not require shareholder approval of a reorganization if the prospective impact of the transaction on the shareholders of a corporate party will not be significant.[50] The significance of impact is ordinarily measured by the voting power that a shareholder group will possess in the combined enterprise after the reorganization. In general, if the shareholders of a corporate party before a reorganization will own, immediately after the reorganization, equity securities representing *more*

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rations would have the power to refuse to grant a permit unless he concludes that the issuance of these securities is fair, just, and equitable to the outstanding preferred shares as well as to other affected security holders. *Id.* § 25140(c).

49. Even carefully drafted anti-dilution provisions contained in the preferred share contract do not afford complete protection against dilution of the conversion privilege. The issuance of common shares will also affect the dividend and liquidation rights of preferred shares to the extent that the holders of these shares are entitled to "participate" in the dividend and liquidation distributions to be received by the holders of the common shares.

50. Gen'l Corp. Law, *supra* note 1, § 1201(b).

than five-sixths of the voting power of the combined enterprise, they will not be entitled to vote on the reorganization.[51] The theory of this exception is that a group of shareholders do not need the protection of voting on a reorganization if they will possess the degree of ownership and control in the combined enterprise represented by this substantial level of voting power. Conversely, a lower level of voting power represents a sufficient diminution in ownership and control to warrant applying the protective device of shareholder approval.[52]

This exception, which appears in section 1201(b), focuses on the shareholders of each corporate party immediately prior to the reorganization and the voting power that each of these shareholder groups will have in the combined enterprise immediately after the reorganization. Since in a sale-of-assets reorganization the equity securities issued will initially be owned by the selling corporation, this provision takes into consideration the equity securities of the combined enterprise that will be owned immediately after the reorganization by any corporate party as well as those owned by the shareholders of the corporate parties.[53] The ownership of equity securities in the combined enterprise by the shareholders of the corporate parties will arise either as a result of receiving the securities issued in the reorganization or owning securities in the issuing entity immediately prior to the reorganization. However, in computing the prospective ownership of shareholders of a corporate party, equity securities owned before the reorganization as a shareholder of another party to the reorganization will be disregarded.[54] This

51. *Id.* *Compare id. with* DEL. CODE ANN. tit. 8, § 251(f) (1974), which eliminates the requirement for approval by the shareholders of a surviving corporation in a statutory merger if certain conditions are satisfied, including the requirement that the equity securities issued or issuable do not exceed twenty percent of the shares of common stock outstanding immediately prior to the merger.

52. *See* ASSEMBLY REPORT, *supra* note 43, at 93-94. The origin of this voting power dilution test is the rules of the New York Stock Exchange and American Stock Exchange, which require a listed acquiring corporation to obtain the approval of its shareholders if the shares to be issued in a business combination are at least twenty percent of its outstanding shares. NEW YORK STOCK EXCHANGE COMPANY MANUAL § A15 (1968); AMERICAN STOCK EXCHANGE COMPANY GUIDE ¶ 10,032 (1969).

53. It is questionable whether in any transaction both a corporation and its shareholders will own equity securities of the combined enterprise immediately after the reorganization. In a sale-of-assets reorganization, the acquired corporation will initially own the issued equity securities, but ordinarily these securities will not have been distributed to its shareholders at the hypothetical point in time when the voting power of this group's equity securities will be measured. Any voting securities in the combined enterprise that are owned by the shareholders of the acquired corporation immediately before the reorganization will be disregarded in determining their voting power immediately after the reorganization. Gen'l Corp. Law, *supra* note 1, § 1201(b).

54. *Id.*

prevents fortuitous or preconceived cross-ownership from distorting the true dilutive effect of a reorganization on a shareholder group.

A shareholder group's prospective ownership of equity securities must represent more than five-sixths of the combined voting power of the combined enterprise (*i.e.*, the surviving or acquiring corporation or a parent party) in order to be denied the right to vote on the transaction. This means that so long as a corporation proposes to issue *less* than twenty percent of its outstanding shares in a reorganization, it will not have to submit the transaction to its shareholders for their approval. Twenty percent is the breakpoint because this percentage of a company's outstanding shares equals one-sixth of the shares that will be outstanding. Thus, the issuance of less than twenty percent will leave an issuer's shareholders before the reorganization with more than five-sixths of the pro forma voting power. The corollary of this proposition is that the issuance of greater than five times the corporation's outstanding shares to another corporation or its shareholders in a reorganization will deny the prospective recipients of these shares the right to vote on the reorganization.

For the purpose of the voting power dilution exception, warrants and other purchase rights are excluded in determining each shareholder group's prospective ownership of equity securities in the combined enterprise.[55] In computing the voting power of the combined enterprise, it is assumed that equity securities convertible into voting shares, either immediately or in the future, have been converted but that warrants and rights to purchase voting shares have not been exercised.[56] Additionally, shares that are entitled to vote only upon the occurrence of an event that has not occurred are not treated as voting shares in the computation of voting power.[57]

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55. *Id.* The excluded securities are "any warrant or right to subscribe to or purchase . . . equity securities . . . ." *Id.* The exclusion of warrants and subscription rights from the determination of dilutive effect can create an anomalous result. In a reorganization, a corporation can issue debt securities and warrants (exercisable by cancellation of the debt securities) to purchase its shares in an amount which, if exercised, will result in its shareholders before the reorganization owning shares representing five-sixths or less of the voting power of the corporation. Since there is no immediate shift in voting power, apparently the voting power dilution exception of section 1201(b) would apply, and therefore no approval of the reorganization by this corporation's shareholders will be required.

56. *Id.*

57. *Id.* § 194.5. An example of this would be preferred shares that are given the right to vote for the election of directors only if the corporation defaults in the payment of a dividend or a sinking fund payment.

The apparent purpose of excluding warrants and purchase rights in computing a shareholder group's prospective ownership is to prevent a group from being denied the right to vote on a reorganization by issuing that group voting warrants or options with an exercise price that makes the prospect of exercise highly remote.[58] Treating convertible securities as having been converted and warrants and purchase rights as not having been exercised gives recognition to the dilutive effect of the former and not the latter, but the logic of this distinction is open to question. The probability of actual dilution from these types of securities depends not upon their form but upon the relationship of the conversion or exercise price to the market price or value of the underlying shares and the duration of the conversion or subscription right. For example, if a corporation's common shares are trading at $10 on the New York Stock Exchange, it would be fatuous to conclude that debentures convertible at $15 per share are more likely to result in dilution than warrants or options that expire in thirty days and are immediately exercisable at $8 per share.[59]

The section 1201(b) exception turns on the voting power of equity securities to be owned by a shareholder group immediately after the reorganization. Thus, any uncertainty over the number of shares that will be issued in a reorganization or the voting power of the combined enterprise immediately after the reorganization will complicate the application of the voting power dilution exception.[60] For example, if a corporation makes an exchange offer for the outstanding shares of another company, it cannot know the number of shares that it will actually issue because it may not be able to predict with any degree of certainty the extent to which its offer will be accepted. If the number of

58. *See* ASSEMBLY REPORT, *supra* note 43, at 94. See note 59 *infra* for a discussion of the possible difficulty in classifying a security as a convertible security rather than as a warrant.

59. It is not always clear whether a security is a convertible security rather than a warrant or purchase right. The GCL defines "equity security" to mean "any security convertible, *with or without consideration*, into shares . . . ." Gen'l Corp. Law, *supra* note 1, § 168 (emphasis added). An acquiring corporation could issue voting preferred shares not entitled to dividends, with a nominal liquidation preference, and convertible into common shares upon payment of cash equal to some multiple of the market price of the common stock at the time of the reorganization. How would this security be classified for purposes of section 1201(b)?

60. Only uncertainty over the number of shares that will initially be issued in the reorganization creates a problem. Shares that will be issued in a reorganization in the future on the basis of the acquired company's earnings or the market price of the shares issued will not affect the application of section 1201(b) to that reorganization because this section refers to ownership immediately after the reorganization.

shares offered in the exchange is at least twenty percent of the offering corporation's shares outstanding or deemed outstanding, it would seem that the exchange could not properly be authorized without an appropriate vote of the offering corporation's shareholders, notwithstanding the fact that some degree less than 100 percent acceptance of the exchange offer would not trigger the voting power dilution exception.

Additional problems in determining the application of the voting power dilution exception arise because of the considerable time that may elapse between reaching an agreement on the terms of a reorganization and the consummation or "closing" of the transaction. Changes in the capitalization of the corporate parties that occur during this period can affect the prospective voting power of the various shareholder groups and therefore affect the shareholder approval requirement. Thus, it may be initially concluded that a surviving corporation need not submit a merger reorganization to its shareholders because the number of shares to be issued is under twenty percent of the shares outstanding and deemed outstanding. Prior to the closing, the prospective voting power of these shareholders can be diminished by a number of events. An obvious example of diminution is the issuance of additional shares by the corporation to be acquired, such as upon the exercise of employee stock options immediately prior to the merger, or the reduction of the market price of the surviving corporation's shares where the exchange ratio is keyed to market price. Less obvious instances of diminution arise from reductions in the capitalization of the surviving corporation prior to the closing. Examples of this are redemption of convertible or voting preferred shares, sinking fund payments on convertible debt securities, issuer purchases of its own common shares, and events that result in an increase in the conversion price of the issuer's convertible securities.[61] In view of these possibilities, the parties will have to

61. Typical anti-dilution clauses in convertible securities require a downward adjustment in the conversion price if the corporation issues shares at a price less than the conversion price then in effect. For the purposes of these anti-dilution clauses, the issuance of other convertible securities, warrants or options will be treated as an issuance of the shares underlying these other securities, warrants or options. Such a hypothetical issuance may initially result in a reduction of the conversion price. However, the conversion price will often be readjusted upward after the expiration of any unexercised subscription right attendant to the securities that produced the initial adjustment. An upward readjustment of the conversion price will decrease the number of shares that may be issued upon conversion of the convertible securities, and, consequently, will produce a reduction in the voting power of the shareholders of the issuing corporation before the reorganization.

consider and carefully plan all prospective capitalization changes when evaluating whether the dilution in voting power exception is applicable to any corporate party.

3. Exceptions to the Voting Power Dilution Exception

There are three basic exceptions to the section 1201(b) exception to the shareholder approval requirement. The general effect of these exceptions is to require the approval of shareholder groups to a reorganization, irrespective of the degree of any dilution, where the reorganization would create a change in shareholder rights that would normally require shareholder approval. These exceptions arise if (1) the articles of a surviving corporation in a merger reorganization are amended; (2) the holders of any class of shares in a merger or sale-of-assets reorganiztion receive shares of the surviving or acquiring corporation that have different rights, preferences, privileges, or restrictions than the shares being surrendered; or (3) the shareholders of a close corporation receive shares in a corporation which is not a close corporation.

The first of these exceptions appears in section 1201(c). It provides that in a merger reorganization approval of the outstanding shares of the surviving corporation will be required if any amendment is made to the articles of that corporation which would otherwise require such approval. Typical examples of this would be amendments that increase the authorized shares of any class, or create a new class of shares, or modify the rights, preferences, privileges, or restrictions of outstanding shares. Generally speaking, the GCL requires that a majority of the outstanding voting shares approve any amendment of the articles,[62] but in some cases there must also be approval by a majority of the shares of any class affected by the amendment irrespective of any limitations on the voting rights of this class.[63]

Section 1201(d) contains another exception to the voting power dilution exception. This qualification appears to be aimed primarily at so-called "down-stream" or "upside-down" mergers. In this type of transaction a corporation will take over a smaller company or combine with a wholly-owned subsidiary in a statutory merger in which the smaller corporation or subsidiary is the surviving corporation. This will result in the shareholders of the larger company owning all or substan-

62. Gen'l Corp. Law, *supra* note 1, § 902(a).
63. *Id.* § 903(a).

tially all of the voting securities of the surviving corporation. The application of the voting power dilution exception would permit a modification of shareholder rights and privileges to be accomplished without approval of the shareholders of the disappearing corporation.[64]

Accordingly, section 1201(d) requires approval by the outstanding shares of any class of a corporation which is a party to a merger or sale-of-assets reorganization if the holders of shares of that class receive shares in the surviving or acquiring corporation that have different rights, preferences, privileges, or restrictions than those surrendered. In this connection, shares in a foreign corporation received in exchange for a domestic corporation's shares will be treated as having different rights, preferences, privileges, and restrictions.

Although a "down-stream" transaction is usually effected by a statutory merger, section 1201(d) also extends to a sale-of-assets reorganization. This means that shareholders of a selling corporation who receive shares of the acquiring corporation[65] will be entitled to vote on the reorganization if the shares have different rights, preferences, privileges or restrictions than the surrendered shares, even though the shares received will represent in excess of five-sixths of the voting power of the acquiring corporation.[66]

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64. This type of transaction was employed in other states to eliminate accrued and unpaid dividends on preferred shares with cumulative dividend rights. *See, e.g.*, Hottenstein v. York Ice Mach. Corp., 136 F.2d 944 (3d Cir. 1943). The preferred share contract was often drafted to prevent cancellation of accrued preferred stock dividends through amendment of the articles or certificate of incorporation unless the amendment was approved by the holders of the preferred stock. However, the contract often failed to protect these rights in the event of merger.

65. The use of the term "acquiring corporation" in section 1201(d) might enable a down-stream transaction to be accomplished without a vote of the selling corporation's shareholders who receive shares having different rights, preferences, privileges or restrictions than those surrendered. The GCL does not contain any definition of the term "acquiring corporation," but this phrase appears in section 1200. It seems clear from this section that the phrase means only the transferee corporation in a sale-of-assets reorganization, and does not include the parent party of the transferee. If this meaning is carried over into section 1201(d), it would appear that this section would have no application to a down-stream sale-of-assets reorganization in which the transferor corporation's shareholders received shares of a parent party rather than of an acquiring corporation. Thus, a corporation might organize a wholly-owned subsidiary under the laws of another state and transfer its assets to yet another subsidiary of that newly organized subsidiary. The transferor corporation could then distribute the shares of the newly organized foreign subsidiary to its shareholders in cancellation for their shares. See note 66 *infra* for a discussion of the shareholder vote that would be required to effect such a distribution.

66. Since the application of this section seems to turn upon the receipt by the selling

The scope of section 1201(d) appears to overlap section 1201(c) to some degree. The latter section requires approval of a merger reorganization by the shareholders of the surviving corporation if that corporation's articles are amended in a respect that would require shareholder approval. As noted earlier, such an amendment could accomplish a reclassification of a class or series of securities of the surviving corporation. In such a reclassification, the holders of the shares of the class or series reclassified would be receiving shares having different rights, preferences, privileges, and restrictions. Thus, section 1201(d) would also come into play. However, the protective reach of section 1201(d) in its application to a merger reorganization is broader than section 1201(c). The latter only operates if the surviving corporation amends its articles, while the former applies if the shareholders of either party to the merger receive securities having different rights. On the other hand, section 1201(c) requires approval by the vote required to amend the articles, but section 1201(d) only requires approval by a majority of the class receiving shares that differ from the shares surrendered. Of course, this distinction will be unimportant when a corporation has only one outstanding class of shares.

The last exception to the voting power dilution exception, which appears in section 1201(e), qualifies both that exception and the section 1201(a) requirement that a reorganization be approved by the holders of a majority of the shares of each class. If a reorganization involves the holders of shares of a close corporation receiving shares of a corporation that is not a close corporation, section 1201(e) requires that the reorganization be approved by the holders of two-thirds of each class

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corporation's shareholders of securities of the acquiring corporation, it is not clear whether these holders would be entitled to vote on a sale-of-assets reorganization if the selling corporation retains these shares and does not distribute them to its shareholders. Under these circumstances, the selling corporation would become a holding company of the acquiring corporation and its business. The shareholders of the holding company would be left with their shares in that enterprise but may have less control over the business that was sold because of its operation as a subsidiary.

If earlier shareholder approval of the reorganization is not required and if the shares of the acquiring corporation are later distributed to the shareholders of the holding company, it is not clear whether section 1201(d) would then require approval of the original reorganization by the recipient shareholders. Distribution of the shares of the acquiring corporation by the holding company would in all likelihood be viewed as a winding-up and dissolution and therefore require shareholder approval. *See* Gen'l Corp. Law, *supra* note 1, § 1900(a). However, the vote required in such a case might be less restrictive than would be required for approval of a reorganization. *Compare id.* § 1201(d) *with id.* § 1900(a).

of the close corporation.[67] The articles of the close corporation may provide for a lower vote but not less than a majority of each class. As in the case of section 1201(a), section 117 requires that the section 1201(e) vote be of each class of shares irrespective of limitations or restrictions on voting rights. The obvious purpose of section 1201(e) is to prevent a reorganization from being used to terminate the close corporation status of a company without the vote that would normally be required to accomplish this end. Section 158(c) permits this status to be terminated by an amendment to the articles approved by the holders of two-thirds of each class, but the articles may deny any class a vote on this subject.

4. Formalities for Obtaining Shareholders' Approval

The required approval of shareholders of a corporation may be given before or after the approval of its board of directors.[68] Subject to the contractual rights of third parties, a board may abandon a reorganization even after shareholder approval has been given without further shareholder action.[69] Shareholder approval may be accomplished either by a vote at a shareholders' meeting or by the written consent of the shareholders of the required proportion of the shares of each class entitled to vote on the reorganization.[70] The vote may be taken either at an annual or a special meeting of shareholders,[71] but in either case the notice of meeting or any waiver of notice must state the general nature of the proposal to be acted upon.[72] Additionally, the notice must

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67. Section 1111 requires the same vote in any merger in which the disappearing corporation is a close corporation but the surviving corporation is not, without reference to whether the shareholders of the close corporation receive non-close corporation shares. A "close corporation" is a domestic corporation with ten or fewer shareholders that has elected to become subject to the close corporation sections of the GCL by provision in its articles. *Id.* § 158(a). The purpose of the close corporation provisions is to enable a corporate enterprise with relatively few shareholders to conduct its affairs as a partnership without subjecting the shareholders to liability for corporate obligations. For a summary description of these provisions see Barton, *A Brief Look at the New California General Corporation Law*, 51 L.A.B.J. 211-12 (1975).

68. Gen'l Corp. Law, *supra* note 1, § 1201(f).

69. *Id.*

70. *Id.* § 603(a).

71. *See id.* § 601(a).

72. *Id.* § 601(f). Section 1201(a) requires that the "principal terms" of the reorganization be approved by the shareholders. Accordingly, in addition to the requirement that the notice of meeting state the general nature of the proposal, any proxy statement used to solicit proxies to vote on the reorganization at the shareholders

summarize certain of the GCL dissenters' rights provisions if the exception to dissenters' rights for certain marketable securities is to be applicable.[73]

If shareholder approval is to be obtained by written consent, either the consent of all shareholders must be solicited or written notice of the approval must be given to all shareholders entitled to vote who have not given their consent at least ten days prior to the consummation of the reorganization.[74] Any written consent may be revoked prior to the time that written consents of the number of shares required to approve the reorganization are filed with the secretary of the corporation.[75]

Any form of proxy or written consent distributed to more than ten shareholders of a corporation having at least 100 shareholders of record must give the shareholder the opportunity to specify a choice between approval and disapproval of the reorganization and to abstain from voting on the transaction.[76] A form of proxy must also provide that the shares will be voted in accordance with the choice specified by the shareholder.[77] These requirements do not apply to any corporation with an outstanding class of securities registered under section 12 of the Securities Exchange Act of 1934[78] or whose securities are exempted from such registration by section 12(g)(2) of that act.[79] Furthermore, failure to comply with these requirements will not invalidate any corporate action, but may be the basis for challenging any proxy at a meeting.[80]

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meeting should contain a copy of the reorganization agreement or at a minimum a complete and accurate summary of the principal terms of the reorganization. In this connection, see Item 14 of Schedule 14A to the proxy rules of the Securities and Exchange Commission, SEC Reg. 14A, 17 C.F R. § 240.14a-1 to .14a-12 (1975), for a description of the formal disclosure requirements in a proxy statement applicable to a business combination involving a publicly held company subject to these rules.

73. Gen'l Corp. Law, *supra* note 1, § 1300(b)(1).

74. *Id.* § 603(b)(1).

75. *Id.* § 603(c).

76. *Id.* §§ 604(a), (b).

77. *Id.* § 604(a). If a shareholder marks his proxy "abstain" with respect to the proposal, the shares covered by the proxy may not be voted either for or against the proposal. *Id.* § 604(b).

78. 15 U.S.C. § 78 (1970).

79. 15 U.S.C. § 78*l*(g)(2) (1970); *see* Gen'l Corp. Law, *supra* note 1, § 604(d). The proxy requirements for issuers whose securities are so registered are governed by section 14 of the Securities Exchange Act of 1934, 15 U.S.C. § 78n (1970), and SEC Reg. 14A, 17 C.F.R. § 240.14a-1 to .14a-12 (1975)

80. Gen'l Corp. Law, *supra* note 1, § 604(e). The superior court may compel compliance with these requirements at the suit of any shareholder. *Id.*

D. *Statutory Merger—Requirements and Effect*

Section 1100 establishes the authority for two or more domestic corporations to "be merged into one of such corporations." The GCL also permits mergers between domestic and foreign corporations if the laws under which the foreign corporations are organized permit such mergers.[81] The surviving corporation in such a transaction may be either a domestic or foreign corporation, which will continue to exist under the laws of its state or place of incorporation.[82] If the surviving corporation is a domestic corporation, the merger proceedings with respect to that corporation and any domestic disappearing corporation must meet the requirements either for a short-form merger or for a merger reorganization between domestic corporations.[83] In the case of a surviving foreign corporation, the merger proceedings with respect to the survivor and all domestic constituents may be in accordance with the laws of the state of incorporation of the survivor.[84] However, the GCL requirements for shareholder approval, dissenters' rights, and payments for fractional shares will in any case apply to the domestic constituents, and to any domestic corporation which is a parent party of any foreign constituent.[85]

Like prior law, the GCL contains a series of formal requirements for the accomplishment of a statutory merger between domestic corporations and between domestic and foreign corporations.[86] The ensuing paragraphs will review and analyze these requirements.

1. The Merger Agreement

The agreement of merger must be approved by the directors of each constituent corporation. The agreement must include the terms and conditions of the merger, any amendments to be made to the surviving

81. *Id.* § 1108(a). The term "corporation" is defined in the GCL as meaning a domestic corporation organized under the GCL as well as a domestic corporation which (1) is not subject to Division 2 or Parts 1, 2, 3, 5 or 6 of Division 3 of Title 1 of the California Corporations Code on December 31, 1976, and (2) is not organized or existing under any California statute other than the California Corporations Code. *Id.* §§ 102(a), 162. "Foreign corporation" means any corporation other than a domestic corporation; this encompasses corporations organized in other countries as well as other states and under federal laws. *Id.* § 171.

82. *Id.* § 1108(a).

83. *Id.* § 1108(b).

84. *Id.*

85. *Id.* §§ 1108(b), (e).

86. *Compare* CAL. CORP. CODE ANN. §§ 4103-24 (West 1955) *with* Gen'l Corp. Law, *supra* note 1, §§ 1100-11.

corporation's articles, the name and place of incorporation of the surviving corporation as well as of each constituent corporation, and information about the manner of share conversion and the type of value to be received in exchange for such shares.[87] Each constituent corporation must sign the agreement of merger by the signature of its chairman of the board, president or vice president, and its secretary or assistant secretary.[88]

The agreement of merger must contain any amendments to be made to the articles of the surviving corporation,[89] and the agreement must in this respect comply with the requirements for establishing the wording of amendments in certificates of amendment.[90] Amendments to articles that typically are made in connection with a merger include the authorization of additional shares or a new class of shares to be issued in the merger and a change in the corporate name of the surviving corporation. In this connection, the GCL permits the name of the surviving corporation to be the same as or similar to that of a disappearing corporation.[91] However, in changing its name the surviving corporation must comply

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87. Gen'l Corp. Law, *supra* note 1, § 1101. The merger agreement must state:

(a) The terms and conditions of the merger;

(b) The amendments . . . to the articles of the surviving corporation to be effected by the merger, if any; . . .

(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] the cash, property, rights or securities of any corporation . . . [to be received] in exchange for such shares . . . ; and

(e) Such other details or provisions as are desired, . . . including, . . . the payment of cash in lieu of fractional shares . . . .

Id.

88. *Id.* § 1102.

89. *Id.* § 1101(b). The corporation's power to amend its articles as a part of a merger is subject to section 900 which provides the general enabling power to a corporation to amend its articles. *Id.*

90. *Id.* The requirements for wording of certificates of amendment appear in *id.* § 907. However, the last paragraph of section 905 substitutes the filing of a merger agreement and officers' certificate, as required by section 1103, for the filing of a certificate of amendment, in order to satisfy the filing requirements for an amendment to articles incident to a merger reorganization.

91. *Id.* § 1101(b). This provision eliminates an obstacle created under prior law by the California Secretary of State's refusal to file a merger agreement if it changed the name of the surviving corporation to the name of a disappearing domestic corporation or a disappearing foreign corporation that was qualified to transact intrastate business in California. The Secretary based this policy on CAL. CORP. CODE ANN. § 310 (West 1955), which prohibited the Secretary from filing articles which set forth a name that was the same as or similar to that of a domestic corporation or a foreign corporation authorized to transact business in this state. This policy could only be circumvented by resorting to artifices such as a fictitious intermediary.

with the GCL provision designed to prevent the adoption of misleading corporate names.[92]

The requirement that the agreement state the name and place of incorporation of each constituent corporation and identify the surviving corporation apparently has a two-fold purpose. It naturally serves to identify the parties and their respective roles in the transaction, and it alerts the office of the Secretary of State to the possible relevance of the GCL provisions that are applicable to mergers between domestic and foreign corporations.

The agreement of merger may be amended with the approval of the boards of directors of the constituent corporations and, unless the shareholder approval obtained included approval of the agreement as amended, with the further approval of the shareholder groups entitled to vote on the reorganization.[93] At any time prior to the effectiveness of a merger it may be abandoned by a constituent corporation at the discretion of its board of directors and without further approval of its shareholders.[94] The statutory right of abandonment is not intended to foreclose an action for breach of the agreement of merger either by a party to the agreement or by a third party beneficiary. Accordingly, any abandonment will be subject to the contractual rights of the other constituent corporations as well as the rights of other third parties.[95]

2. Permitted Consideration and Forms of Mergers

The agreement of merger must state what disposition will be made of the outstanding shares of each of the constituent corporations. The GCL specifies the following three possibilities: (1) the conversion of shares of the constituents into shares or other securities of the surviving corporation; (2) the exchange of shares of constituent corporations for cash, property, rights, or securities of any corporation other than the surviving corporation; or (3) a combination of conversion into shares or other securities of the surviving corporation and the exchange of shares for cash, property, rights, or securities of any other corporation.[96] While not expressly stated in the GCL, an obvious fourth possibility is for the shares of a constituent corporation to remain unchanged. The effect of these possibilities is generally to permit the use of any form or combination of forms of consideration in a merger, as well as the accomplish-

92. Gen'l Corp. Law, *supra* note 1, § 1101(b). The provision governing the adoption of corporate names appears in section 201(b).

93. *Id.* § 1104.

94. *Id.* § 1105.

95. *Id.*

96. *Id.* § 1101(d).

ment of three basic forms of merger, *i.e.*, the straight merger, the triangular merger, and the reverse merger.

In a straight merger, the company to be acquired is generally the disappearing corporation which merges into the surviving corporation. The shareholders of the former receive shares or securities of the latter. In the triangular merger the acquired corporation is also the disappearing corporation but merges into a wholly-owned subsidiary of the corporation whose shares or securities are issued to the shareholders of the disappearing corporation. This form of merger is employed when the acquiring corporation desires to have the business and assets of the acquired corporation operated as a separate corporate entity. In this form of merger, the subsidiary is the surviving corporation, but it does not issue its shares or securities to the shareholders of the disappearing corporation.

The reverse merger (sometimes called a "phantom" merger) is a variant of the triangular transaction and is so named because the surviving and disappearing roles of the merging entities are reversed.[97] The wholly-owned subsidiary of the parent party becomes the disappearing corporation and merges into the corporation to be acquired, which is the surviving corporation. The outstanding shares of the disappearing corporation are converted into shares of the surviving corporation, and the shares of the surviving corporation are exchanged for shares or securities of the parent party. The result of this form of merger is that the acquired corporation becomes a wholly-owned subsidiary of the parent party, and the shareholders of the acquired corporation become security holders of the parent party.[98] Since this form of transaction does not disturb the corporate existence, assets, or liabilities of the acquired corporation, the reverse merger is used when there is concern that a transfer of assets, even if accomplished by operation of law, might adversely affect contractual or other property rights or relationships of that corporation.

The conversion and exchange requirements of the basic merger statute also enable a merger to be used as a vehicle for reclassifying the outstanding shares of the surviving corporation and for distributing cash or other property to the shareholders of the constituent corporations. Examples of such a reclassification would be the conversion of a class or series of preferred shares into shares without preferences or with different preferences or rights and the conversion of common shares into

97. J. FREUND, ANATOMY OF A MERGER 79 (1975).
98. *Id.*

shares with preferences. Normally, it will not be advisable to utilize a merger to reclassify shares of the surviving corporation unless the reclassification is an integral part of the reorganization plan. Absent a reclassification, which requires an amendment to articles, the voting power dilution exception of section 1201(b) may enable the surviving corporation to avoid submitting the merger to its shareholders for their approval. Even if this approval is required, shareholders who dissent from a merger and reclassification will be entitled to dissenters' rights. These rights are not available to shareholders who dissent from a reclassification effected by an amendment to articles absent a reorganization.[99]

There is no particular advantage under the GCL to distributing cash or other property as an incident to a merger in which shares or other securities are issued. Transfers of cash or other property to any shareholder group will be subject to the statutory limitations on dividends and other distributions to shareholders appearing in Chapter 5 of the GCL.[100] Additionally, the distribution of cash or other property in a merger involving the issuance of securities may have adverse tax and accounting consequences.[101]

3. Limitations on Merger Consideration and the Merger as a Device to Eliminate Minority Interests

Prior law contained no statutory prohibition against using a merger or consolidation as an instrument to eliminate or "squeeze out" dissident or other minority interests in a corporation. As a consequence, the statutory merger was employed as a squeeze-out device.[102] For example, the

99. Gen'l Corp. Law, *supra* note 1, § 1300.

100. *Id.* §§ 166, 500-03. See note 220 *infra* for a brief description of these limitations. Prior law permitted the distribution of cash and other property in a merger so long as the liabilities of the surviving corporation, including those derived from the disappearing corporation, and its stated capital did not exceed the value of its assets. CAL. CORP. CODE ANN. § 4103 (West 1955).

101. See note 224 *infra* and text accompanying notes 310-25 *infra*.

102. Apart from merger transactions, two additional techniques were employed in an attempt to squeeze out minority interests over their objection. One was a reverse stock split of enormous proportion which left the minority shareholders with only fractional interests in the new shares. These interests were then paid off in cash, thus completing the squeeze-out. With the adoption of the California Corporate Securities Law of 1968, CAL. CORP. CODE ANN. §§ 25000-804 (West Supp. 1975), this type of transaction became subject to the qualification requirements of that law, and accordingly this mechanism cannot be employed without approval of the California Commissioner of Corporations. CAL. CORP. CODE ANN. §§ 25103(f)(3), 25120 (West Supp. 1975). The second technique for eliminating minority interests, which has been prohibited by the California courts, was a dissolution of the corporation in which the majority shareholders took the operating assets and the minority was given cash. *See* Zimmerman v. Tide

majority shareholders of a corporation would exchange their shares for the shares of another corporation. The second corporation would then merge with the first corporation, and the minority shareholders of the latter would receive cash or unattractive debt securities for their interests. Alternatively, a corporation would be formed by the majority shareholders of a company, and a merger would be effected between that corporation and the company with the unwanted minority. As in the first type of transaction, the minority would receive cash or debt securities and the majority shares. In a variation of the second type of transaction, the majority shareholders of a corporation contribute their controlling shares to a new corporation in exchange for all of the shares of that company, thus creating a parent and subsidiary relationship between the new corporation and the first corporation. In a merger of the subsidiary into the parent corporation, the minority shareholders of the subsidiary are given cash or debt securities, the shares of the subsidiary held by the parent are cancelled and the former majority shareholders of the subsidiary corporation become the sole shareholders of that enterprise by reason of their shareholdings in the parent corporation.

The principal state law remedy for the minority shareholders in these types of transactions was the exercise of dissenters' rights. But this remedy only provided the minority with cash and did not prevent the elimination of their interests in the corporation without their approval.[103] The drafters of the GCL decided to remedy the prior law's insensitivity to squeeze-out devices by having the GCL circumscribe the methods that can be employed to cash-out or eliminate minority interests without their approval. Accordingly, the GCL reflects a rather clear policy to permit the elimination of a ten percent or smaller interest in a

Water Associated Oil Co., 61 Cal. App. 2d 585, 143 P.2d 409 (1943); *In re* San Joaquin Light & Power Co., 52 Cal. App. 2d 814, 127 P.2d 29 (1942). *See also* Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 38 Cal. Rptr. 148 (1964), in which minority shareholders successfully challenged the sale-of-assets of the corporation to a corporation controlled by a majority shareholder of the first corporation. The sales price was equal to fair market value but was payable in cash over an extended period of time, thus having the effect of eliminating the interest of the minority in a profitable venture.

103. The statutory merger as a squeeze-out device has been held to be unlawful as a breach of the fiduciary obligation of controlling shareholders to the minority shareholders. *See* Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974), discussed in note 168 *infra*; Jutkowitz v. Bourns, Los Angeles Super. Ct. Case No. CA000268 Memorandum of Decision (Nov. 19, 1975), discussed in note 138 *infra*; *accord*, People v. Concord Fabrics, Inc., 371 N.Y.S.2d 550 (Sup. Ct. 1975). This type of transaction has also been held to violate rule 10b-5, 17 C.F.R. 240.10b-5 (1975), of the Securities and Exchange Commission [hereinafter cited as Rule 10b-5]. Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2nd Cir. 1976), discussed in text at notes 117-22 *infra*.

corporation,[104] but to proscribe the elimination of a greater interest.

The policy of prohibiting the elimination of larger minority interests was implemented by limiting the type of consideration that may be given in a statutory merger under certain circumstances. These limitations, which appear in section 1101, are two in number. The first requires that in a merger "each share of the same class or series of a constituent corporation . . . shall . . . be treated equally with respect to any distribution of cash, property, rights, or securities," unless all shareholders of that class or series otherwise consent.[105] This requirement assures equality of treatment for identical securities and therefore precludes discrimination against minority shareholders as to the type of consideration that is given for their shares. This requirement is subject to three exceptions. It has no application to a short-form merger authorized under section 1110.[106] Additionally, fractional share interests may be treated in the manner provided in section 407 without contravening the equality requirement.[107] Finally, shares of the acquired corporation held by the surviving corporation or its parent or a wholly-owned subsidiary of either may be cancelled.[108]

The second limitation on the type of consideration which may be given in a merger reorganization applies to a transaction in which a specified control relationship exists between the parties to the merger. The provision containing this limitation states:

> [T]he nonredeemable common shares of a constituent corporation may be converted only into nonredeemable common shares of the surviving corporation or a parent party if a constituent corporation or its parent owns, directly or indirectly, 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 . . . .[109]

Like the equal treatment requirement, this provision has no application to short-form mergers and does not prevent the payment of cash for fractional shares within the limitations of section 407.[110] The principal

104. The permitted methods of elimination are the short-form merger, see text accompanying notes 147-81 *infra*, and the reverse stock split followed by a payment of cash for the fractional share interests. See note 145 *infra*.

105. Gen'l Corp. Law, *supra* note 1, § 1101.

106. *Id.* See text accompanying notes 147-81 *infra*.

107. Gen'l Corp. Law, *supra* note 1, § 1101. See text accompanying notes 241-45 *infra*.

108. Gen'l Corp. Law, *supra* note 1, § 1101.

109. *Id.*

110. *Id.*

effect of this provision is to require the exchange of nonredeemable common shares for nonredeemable common share interests in a merger reorganization between parties with the specified affiliation prior to the merger unless all recipient shareholders consent to the contrary. No limitation is placed on the type of consideration that may be exchanged for preferred shares or redeemable common shares so long as the equal treatment requirement is satisfied.

The affiliation that brings into play this common share exchange requirement is the direct or indirect ownership of shares representing more than fifty percent of the voting power of a constituent corporation. The owning party must be either another constituent corporation or a parent of that constituent. For purposes of section 1101 the "parent" of a corporation means a person[111] who owns, directly or indirectly, shares representing more than fifty percent of the voting power of that corporation.[112] Since the indirect ownership of shares of a constituent corporation can create a parent relationship to that corporation, the parent of the parent of a constituent may or may not also be a parent of the constituent. Indirect or direct parent status will depend upon the percentage of the constituent's shares owned by its immediate parent as well as the percentage of that parent's shares owned by the parent of that parent.[113] In summary, the requisite controlling block of shares of a constituent corporation that will trigger the common share exchange requirement can be owned by any of the following persons: (1) the other constituent corporation, (2) a parent of the other constituent corporation, (3) a person who is both a parent of the parent of the other constituent corporation as well as a parent of that constituent itself, and (4) a corporation or other entity wholly-owned by any of the owning persons specified in (1), (2) or (3).[114]

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111. The term "person" includes a corporation as well as a natural person. CAL. CORP. CODE ANN. § 18 (West 1955). This definition appears in the general provisions of the prior Corporations Code and was not modified by the GCL.

112. Gen'l Corp. Law, *supra* note 1, §§ 160(b), 175.

113. If the immediate (*i.e.*, first) parent of the constituent corporation owns all of the voting shares of the latter, the second parent's ownership of voting shares of the first parent, even if only the minimum necessary for parent status, should also constitute indirect ownership of shares possessing more than fifty percent of the voting power of the constituent (*i.e.*, 50.1% x 100% = 50.1%). However, if the direct ownership by the first parent of the shares of the constituent and by the second parent of the shares of the first parent are the minimum required for parent status, the second parent's indirect ownership of shares of the constituent will not be sufficient for parent status (*i.e.*, 50.1% x 50.1% = 25.1%).

114. This conclusion is derived from the reference in section 1101 to direct or *indirect* ownership by a constituent corporation or its parent of shares of another

By requiring the exchange of nonredeemable common shares, section 1101 prohibits the immediate elimination of minority common share interests which would be produced by the payment of cash or the issuance of debt securities. The future involuntary elimination of these interests is also precluded by the requirement that securities issued may not be redeemable. Thus, the holder of a permanent common share investment in a controlled corporation is assured that his investment will be converted into a similarly permanent equity investment in the controlling enterprise.

The common share exchange requirement contains one apparent defect. It cannot be waived without the unanimous approval of the holders of the class of shares that would be eliminated through the payment of prohibited consideration. This seems unduly strict and appears to go beyond what is necessary to protect minority interests. The vast majority of the minority share interests in a merger may prefer debt securities or cash rather than shares for their minority interests. However, a single opposing vote or, even more likely, the failure of any shareholder to vote, will preclude this, except insofar as cash can be paid upon the exercise of dissenters' rights. This permits the holder of a single share to dictate the type of consideration that will be received by the remaining shareholders. It would have been more logical to permit noncommon share consideration for common shares in a merger involving affiliates if the consideration were approved by the holders of a majority of the shares of the corporation exclusive of shares owned by persons affiliated with the paying corporation.

There may also be a defect in the GCL's application of both the equal treatment and common share exchange requirements for mergers between foreign and domestic corporations. Section 1108(b) provides that in such a merger, if the surviving corporation is a foreign corporation the merger proceedings may be in accordance with the laws of the state of incorporation of that corporation. The same section specifically provides for the application of the fractional share, shareholder approval and dissenters' rights provisions of the GCL to the domestic disappearing corporations, thus extending the protective features of these provisions to the shareholders of the California corporations. However, there is no similar provision which applies the equal treatment and common share exchange requirements to such a transaction.[115]

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constituent corporation. Ownership of shares by a wholly-owned entity would constitute indirect ownership of the shares by the owner of that entity.

115. See note 291 *infra* for a discussion of the GCL's application of these protective

The objective of the common share exchange requirement may become embodied in rule 10b-5 of the Securities and Exchange Commission[116] if the view of the Second Circuit Court of Appeals in *Marshel v. AFW Fabric Corp.*[117] is adopted by other federal courts. This case dealt with the application of a New York long-form merger statute to a "going private" merger. In this transaction the Weinstein family transferred its 68% interest in publicly-held Concord Fabrics, Inc. to defendant AFW Fabric Corp. The family then sought to eliminate the minority shareholders by having Concord merge into AFW with the minority to receive $3 in cash for each of their Concord shares. As the sole shareholder of AFW, the Weinsteins would have owned the entire business of Concord after the merger eliminated the minority interests.[118]

requirements to "pseudo foreign" corporations which are governed by section 2115 of the GCL.

116. Rule 10b-5, *supra* note 103.

117. 533 F.2d 1277 (2nd Cir.), *en banc rehearing denied*, 533 F.2d 1309 (1976). In denying the rehearing the court of appeals, per curiam, stated that rehearing en banc was denied because of the confidence of the Second Circuit judges who, when polled, indicated that this decision was of such importance that it would be heard by the Supreme Court. 533 F.2d at 1310. The court also stated that it felt that an en banc hearing was inappropriate in this case because two judges were disqualified from participating and thus the law of the circuit might have been established with only the concurrence of a minority of the acting judges. *Id.*

118. Concord Fabrics, Inc. had made a public offering of 300,000 shares in 1968 at $15 per share, and in 1969 the Weinstein family, the controlling shareholders of Concord, sold 200,000 shares in a secondary public offering at $20 per share. As a result of these two offerings the holdings of the Weinsteins were reduced to approximately sixty-eight percent of Concord's outstanding shares, and the remaining approximately thirty-two percent was held by the public. As a result of a severe decline in Concord's earnings, corporate losses and stock prices, Concord's shares went from a high of $25 in 1969 to a low of $1 in 1974. Concord's operations became profitable again in 1973. 533 F.2d 1277, 1279.

In 1975 the Weinsteins decided to return Concord to a private rather than public status by means of a cash tender offer for all of the publicly held Concord stock at $3 per share. The Weinsteins transferred their controlling interest in Concord to defendant AFW Fabric Corp. (AFW) in exchange for all of the stock of AFW. AFW then tendered for the publicly held Concord shares, and in its published offer advised the Concord shareholders that after the offer expired AFW would cause a merger between Concord and itself regardless of whether any shares were tendered. The public offer also stated that the unpurchased Concord stock would be canceled with each minority shareholder to receive $3 per share in cash for his canceled stock, and that in view of AFW's sixty-eight percent interest in Concord the stockholders who did not tender their shares would be unable to block the merger by voting against it. *Id.*

Plaintiff Marshel, a minority shareholder of Concord, brought an action in the United States District Court for the Southern District of New York to have the tender offer enjoined. *Id.* Another minority shareholder brought a similar action in state court. The AFW tender offer was withdrawn shortly after the institution of these actions, and AFW proceeded with the merger phase of the going private transaction. The merger proxy statement stated that the purpose of the merger was to return Concord to a private status

The Court of Appeals observed that the substance of the merger was that, after having raised over $7,800,000 from public financings, the Weinsteins sought to appropriate the entire public stock of Concord for themselves at a cost to Concord of approximately $1,600,000.[119] The court held that,

> when controlling stockholders and directors of a publicly-held corporation cause it to expend corporate funds to force elimination of minority stockholders' equity participation for reasons not benefiting the corporation but rather serving only the interests of the controlling stockholders . . . ,[120]

such a merger is a fraudulent scheme which violates section 10(b) of the Securities Exchange Act of 1934[121] and rule 10b-5.[122]

4. Filing Requirements

Section 1103 provides that after a merger is approved by the boards of directors of the constituent corporations and the required shareholder approval has been given, the merger is effectuated by the surviving corporation's filing a copy of the merger agreement and an officers' certificate of each constituent corporation with the California Secretary of State.[123] As a condition to this filing the disappearing corporations

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and thereby cause the Weinstein family to be the sole stockholders of Concord. The plaintiff Marshel amended his complaint in the district court to enjoin the merger on the grounds that, *inter alia*, the merger violated rule 10b-5. The district court denied Marshel's motion for a preliminary injunction, 398 F. Supp. 734 (S.D.N.Y. 1975), and the court of appeals reversed this decision. 533 F.2d at 1278.

119. *Id.* at 1280.

120. *Id.* at 1281.

121. 15 U.S.C. § 78j(b) (1970) [hereinafter cited as Section 10(b)].

122. Rule 10b-5, *supra* note 103.

123. An "officers' certificate" is defined in the GCL as a certificate signed and verified by the chairman of the board, the president or any vice president, and by the secretary, the chief financial officer, the treasurer, or any assistant secretary or assistant treasurer. Gen'l Corp. Law, *supra* note 1, § 173. The term "verified" means that the statements made in the certificate

> are declared to be true of the own knowledge of the persons executing the same in either:
> (a) An affidavit signed by them under oath before an officer authorized by the laws of this state or the place where it is executed to administer oaths, or
> (b) A declaration in writing executed by them "under penalty of perjury" and stating the date and place (whether within or without this state) of execution.

Id. § 193. The officers' certificate must be attached to the merger agreement when filed with the Secretary of State. It is required to state the total number of outstanding shares of each class of the corporation entitled to vote on the merger, and the percentage vote required of each class, and that the agreement in the form attached was approved by that corporation by a vote of a number of shares of each class which equaled or exceeded the vote required, or that the merger was entitled to be approved by the board alone under section 1201. If equity securities of a parent of a constituent corporation are to be issued in the merger, the certificate must state either that no vote of the shareholders of

must first file with the Secretary a certificate of the Franchise Tax Board to the effect that all taxes imposed by the Bank and Corporation Tax Law have either been paid or secured.[124] This certificate can usually be obtained by the surviving corporation's presenting to the Franchise Tax Board a written undertaking assuming all of the obligations of the disappearing corporation to pay all taxes, interest and penalties owing or to become due under that law.

The merger and any amendment to the articles of the surviving corporation contained in the agreement of merger will become effective upon filing the agreement of merger and officers' certificates with the Secretary of State.[125] The effectiveness of a merger and any amendments to articles is subject to two exceptions. Section 110(c) states that an agreement of merger may provide that it will become effective up to ninety days after it is filed with the Secretary of State.[126] If the agreement provides for a delayed effectiveness, it may be revoked and will not become effective if prior to the specified effective date a certificate revoking the filing executed on behalf of one of the constituent corporations is filed with the Secretary of State.[127] If no certificate of revocation is filed, the merger and amendment to articles become effective on the date specified in the agreement of merger.[128]

Section 1103 permits the Secretary of State to certify a copy of the merger agreement separate from the officers' certificates. Section 1106 provides that a copy of the merger agreement certified on or after the effective date by an official having custody of the original has the same force in evidence as the original and, except as against the state, is conclusive evidence of the performance of all conditions precedent to the merger, the existence on the effective date of the surviving corporation, and the performance of the conditions necessary to the adoption of any amendments to the articles contained in the merger agreement.

If the merger involves domestic and foreign corporations, the filing requirements and effectiveness of the merger depend upon whether the

the parent was required or that the required vote was obtained. *Id.* § 1103. *Compare id. with* CAL. CORP. CODE ANN. § 4110 (West 1955).

124. Gen'l Corp. Law, *supra* note 1, § 1103. This requirement only applies to disappearing corporations that are taxed under the Bank and Corporation Tax Law. *Id.*

125. *Id.*

126. The origin of this provision appears to be DEL. CODE ANN. tit. 8, § 103(d) (1974). In addition to providing for delayed effectiveness in the instrument, the party submitting the instrument may request the California Secretary of State to withhold that instrument from filing for a period, not in excess of ninety days from receipt. Gen'l Corp. Law, *supra* note 1, § 110(a).

127. *Id.* § 110(c).

128. *Id.*

surviving corporation is domestic or foreign.[129] If the survivor is a domestic corporation, the agreement of merger and officers' certificate of each domestic or foreign constituent corporation must be filed with the California Secretary of State. Subject to section 110(c), upon such filing the merger will be effective as to all domestic constituents, as in the case of a merger between domestic corporations.[130] Although the GCL is silent on this point, the merger will presumably become effective as to the foreign disappearing corporation in accordance with the laws of its jurisdiction of incorporation. However, if a foreign disappearing corporation is qualified to transact intrastate business in California, the filing with the California Secretary of State will be treated as an automatic surrender of that right.[131]

If the surviving corporation is a foreign corporation, the merger will become effective as to the survivor in accordance with the laws of its jurisdiction of incorporation.[132] A copy of the agreement, certificate, or other document filed by the surviving corporation in that jurisdiction for the purpose of effecting the merger must be filed with the California Secretary of State.[133] The copy filed must either be an executed counterpart of that agreement, certificate or document or must be certified by the public officer having custody of the original.[134] Upon this California filing, the merger will become effective as to the disappearing domestic corporations as of the time of the filing in the foreign jurisdiction.[135] The filing will also be treated as an automatic surrender of the right to transact intrastate business in California by any disappearing foreign corporation that was qualified to transact that business.[136] If the surviving foreign corporation is not so qualified it may be required to qualify by reason of continuing the activities of the business or properties

129. *Id.* §§ 1108(b), (c), (d).

130. *Id.* § 1108(c).

131. *Id.* The prior law required a separate filing by the disappearing foreign corporation to surrender its right to transact intrastate business in the state. CAL. CORP. CODE ANN. § 4119 (West 1955).

132. Gen'l Corp. Law, *supra* note 1, § 1108(d).

133. *Id.*

134. *Id.*

135 *Id.* Because the provisions of sections 1108(b) and (d) arguably allow only the law of the surviving corporation's state of incorporation to control the effectiveness of the merger, if the merger agreement provides for a deferred effective date and the surviving corporation is a foreign corporation, there may be a question as to whether a disappearing domestic constituent corporation may revoke the merger prior to its effective date under section 110(c). Presumably the merger agreement could in any event expressly permit the disappearing domestic corporation to utilize section 110(c).

136. *Id.* CAL. CORP. CODE ANN. § 4119 (West 1955) also required the filing of a separate certificate for this purpose.

of a disappearing domestic corporation or of a disappearing foreign corporation that was required to be qualified.

Unlike prior law, the GCL does not require that a copy of the merger agreement or a certificate relating to the merger be filed with county officials.[137] However, section 1109 permits county recordation for the purpose of evidencing record ownership of the surviving or consolidated corporation in all real property of a disappearing corporation in that county. The scope of this section is interesting because it extends both to mergers and consolidations wholly between foreign corporations,[138] as well as to mergers involving only domestic or domestic and foreign corporations. This section may be used if the laws of the state of incorporation of any disappearing corporation, including California, provide in substance that the making and filing of an agreement of merger or consolidation will vest all of the real property of a disappearing corporation in the surviving or consolidated corporation. The document recorded will be either a certificate prescribed by the California Secretary of State or a copy of the agreement of merger or consolidation certified by the Secretary or an authorized public official of the state pursuant to whose laws the merger or consolidation is effected. The document will be filed for record with the county recorder of each county in which real property of a disappearing corporation is located.

5. Effect of a Merger

Broadly speaking, a merger accomplishes a legally produced fusion of the constituent corporations. However, the precise effect of a merger is governed by section 1107. This section describes the effect of a merger on the existence of the disappearing corporation; the rights and responsibilities of the surviving corporation with respect to the rights, property, debts, and liabilities of the disappearing corporation; the rights of creditors and lienholders of the disappearing corporation; and the status of pending actions involving the disappearing corporation.[139]

Section 1107(a) states that upon a merger the existence of a disappearing corporation ceases and the surviving corporation succeeds without other transfer to all of the rights and property of the disappearing constituent.[140] This succession is of course subject to the terms of

137. CAL. CORP. CODE ANN. §§ 4114, 4119 (West 1955) mandated certain filings with county officials.

138. CAL. CORP. CODE ANN. §§ 4114, 4119 (West 1955) are of similar breadth.

139. Gen'l Corp. Law, *supra* note 1, § 1107.

140. *Id.* This feature often eliminates the necessity of preparing and executing many instruments of conveyance and transfer. Nevertheless, documents of title will ordinarily require separate assignment, and negotiable instruments and documents will require

contractual rights of the disappearing corporation.[141] Therefore, if an agreement were to provide that transfers of rights by merger are in effect void without the consent of the other contracting party, the agreement would not be enforceable by the surviving corporation against the other parties in the absence of the required consent unless the restrictions were invalid. Since a merger does effect a transfer, albeit by statutory fiat, it would not appear necessary for a restriction on transfer to make specific reference to a merger for the restriction to apply in such an event. Additionally, traditional contract law concepts affecting the assignability of contractual rights undoubtedly apply to succession by merger.[142] The certainty or uncertainty of the effect of these restrictions often dictates the use of a reverse merger to preserve an advantageous contractual arrangement such as a lease, supply contract, or loan which might not be available if a transfer were effected. Since the corporation to be acquired in this form of merger is the surviving corporation, a transfer is avoided and the desired contractual relationship remains undisturbed.

This section also provides that the surviving corporation will become subject to all debts and liabilities[143] of the disappearing corporation "in the same manner as if the surviving corporation had itself incurred them."[144] This language seems to create more than an automatic assumption of debts and liabilities, but the extent of its meaning is not entirely clear. Perhaps it means that the creditors of the disappearing

endorsement unless they are in bearer form. Consent of the granting authority will usually be required to effect a transfer of any franchises, licenses, and permits.

141. *See* Mercantile Trust Co. v. San Joaquin Agricultural Corp., 89 Cal. App. 558, 565, 265 P. 583, 585-86 (1928); *cf.* Mutual Bldg. & Loan Ass'n v. Wiborg, 59 Cal. App. 2d 325, 330, 139 P.2d 73, 75 (1943).

142. There is no California decision directly on this point. The issue was considered in Globe & Rutgers Fire Ins. Co. v. Jones, 89 N.W. 580 (Mich. 1902) in which, after a merger, the surviving corporation attempted to assert rights as a successor under an employment agreement between the disappearing corporation and an employee. The court applied ordinary contract law principles and concluded that the employment agreement was not assignable and, consequently, that it was not transferred by the merger. In the case of mergers involving state banks, however, the California legislature has to a certain degree overridden ordinary contract principles on the assignability of contract rights and the delegation of responsibilities. *See* CAL. FIN. CODE ANN. § 2095 (West 1968).

143. It is interesting to note that both the GCL and prior law refer only to the survivor becoming subject to the "debts and liabilities" of the disappearing corporation. Gen'l Corp. Law, *supra* note 1, § 1107(a); CAL. CORP. CODE ANN. § 4116 (West 1955). In ordinary legal usage these terms would not necessarily encompass obligations created by contract or law that do not directly involve a commitment to pay money. However, the apparent intent of these statutes is to impose all forms of legal obligations of the disappearing corporation on the survivor. The comparable Delaware statute contains the phrase "debts, liabilities and duties." DEL. CODE ANN. tit. 8, § 259(a) (1974).

144. Gen'l Corp. Law, *supra* note 1, § 1107(a).

corporation can enforce their claims against the survivor to the same extent as if the survivor had itself incurred these debts.[145] This would appear to be a fair reading of the provision, but even this interpretation might produce an unfair result. For example, if a surviving corporation is treated as having incurred a debt, may it assert a valid defense to the claim that could not have been asserted by the debtor disappearing corporation?

Section 1107(b) provides that the rights of creditors and liens on the property of both the surviving and disappearing corporations will be preserved unimpaired. However, this provision states that liens on the property of a disappearing corporation are limited to the property so encumbered immediately prior to the effectiveness of the merger. Thus, liens of creditors of a disappearing corporation will, after the merger, extend only to the property they encumbered before the merger, irrespective of any after-acquired property clause in the security instruments creating the liens. This restriction does not apply to liens on property of the survivor, which by operation of such a clause may extend to the property acquired in the merger. However, these liens will be subject to any liens that existed on the acquired property at the time of the merger.[146]

Under section 1107(c), actions pending at the time of a merger involving a disappearing corporation may be continued after the merger. The survivor may either be substituted as a party for the disappearing corporation or the action may be prosecuted to judgment without substitution, in which event the survivor will be bound by that judgment.

6. Short-Form Merger

The short-form merger is a procedure for accomplishing the merger of a substantially or wholly-owned subsidiary into a parent corporation

145. This appears to be the effect of Moe v. Transamerica Title Ins. Co., 21 Cal. App. 3d 289, 98 Cal. Rptr. 547 (1971), a decision involving CAL. CORP. CODE ANN. § 4116 (West 1955), the predecessor of GCL section 1107(a). In this case the court held that the surviving corporation was liable for punitive damages arising from the pre-merger activities of the disappearing corporation. Although the decision did not turn on an interpretation of the language of section 4116, such as that suggested in the text, since the party to be punished by the imposition of punitive damages was no longer in existence, it is arguable that a mere assumption of liabilities would not have produced this result. The Delaware statute is to the same effect as the interpretation suggested in the text. DEL. CODE ANN. tit. 8, § 259(a) (1974).

146. Under prior law liens carried over only to the property they encumbered immediately prior to the combination. CAL. CORP. CODE ANN. § 4116 (West 1955). This may have conflicted with rights authorized under Division 9 of the California Commercial Code. CAL. COMM. CODE § 9101 *et seq.* (West Supp. 1975).

without the necessity of obtaining the formal approval of the shareholders of either corporation. Other than California, the corporation statutes of many states have permitted this procedure for some time, with the minimum required parent ownership of the subsidiary ranging from ninety to ninety-nine percent.[147] Where the subsidiary is not wholly-owned, the short-form merger is in substance a means of eliminating a minority interest and is often accomplished through the payment of cash for minority-held shares rather than the issuance of securities of the parent. In those instances involving wholly-owned subsidiaries, the short-form merger is a simplified procedure for eliminating unwanted subsidiary entities.

Prior to the GCL, a short-form merger could not be used for California corporations unless the subsidiary was wholly-owned by the parent.[148] Thus, any elimination of a minority interest through a merger had to be accomplished by a regular statutory merger. Although this required approval of the shareholders of the subsidiary, this was normally only a formality because the parent's ownership and influence made approval a foregone conclusion.[149] Furthermore, approval of the par-

147. *E.g.*, DEL. CODE ANN. tit. 8, § 253 (1974) (ninety percent ownership required); N.Y. BUS. CORP LAW § 905 (McKinney Supp. 1975) (ninety-five percent ownership required); ILL. ANN. STAT. ch. 32, § 157.66a (Smith-Hurd Supp. 1975) (ninety-nine percent ownership required).

148. CAL. CORP. CODE ANN. § 4124 (West 1955).

149. A recent decision of the Los Angeles Superior Court in a hearing on a motion for a preliminary injunction expresses the view that the prior law merger procedure in a transaction similar to the procedure outlined in the text cannot be employed for the sole purpose of eliminating minority shareholders. Jutkowitz v. Bourns, Los Angeles Super. Ct. Case No. CA000268 Memorandum of Decision (Nov. 19, 1975). In this case the trial judge granted a preliminary injunction to prevent the consummation of a merger that would have resulted in the elimination of a publicly held ten percent minority interest. Relying upon Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), the court concluded that it seemed likely that at trial it would be held that the fiduciary obligations of the majority prevent the forced sale of the minority's stock to the surviving corporation over the objections of the minority.

This decision is of particular interest in that the judge made reference to the GCL regular and short-form merger provisions, admittedly not applicable to the case, because the parties apparently attempted to draw different inferences from these provisions as to the meaning of the prior law merger statutes. The trial judge observed that "[t]he new Code does not do away with the idea that a 'merger' in fact must take place, nor does the new Code purport to eliminate the fiduciary responsibilities of the majority to the minority set forth in Jones v. Ahmanson, *supra*." Memorandum of Decision, at 6. The judge's reference to the GCL's not dispensing with the requirement for a merger clearly reflects a lack of familiarity with the concept of a short-form merger statute. It should be noted that at the time of this decision the common share exchange requirement for affiliated party mergers did not appear in the GCL. The Technical Amendments

ent's shareholders could be avoided by having the subsidiary merge into a wholly-owned subsidiary to whom the partly-owned subsidiary's shares were transferred by the parent. If after the merger between its subsidiaries the parent desired to eliminate the wholly-owned subsidiary, this could be accomplished by a short-form merger.

As observed earlier under the discussion of the equal treatment and common share exchange requirements, the drafters of the GCL decided that the GCL should prohibit the involuntary elimination of minority shareholder interests except as permitted by the short-form merger and payment for fractional share provisions.[150] Section 1110 authorizes a short-form merger if the parent corporation owns at least ninety percent of the subsidiary. The GCL thus sanctions the elimination of a ten percent minority interest in a short-form merger and protects the eliminated minority shareholders by giving them dissenters' rights.[151]

If a short-form merger involves only the absorption of a wholly-owned subsidiary, section 1110(a) provides that it is effected by the adoption of a resolution by the board of the parent corporation and the filing of a certificate of ownership. The resolution must provide for the merger and the assumption by the parent of all of the liabilities of each merging subsidiary. If a parent owns less than all of the outstanding shares of a subsidiary but at least ninety percent of the outstanding shares of each class, the short-form merger will be governed by section 1110(b). In such a case the short-form merger is effected by the adoption of resolutions by the boards of the parent and subsidiary corporations and the filing of a certificate of ownership.[152] The resolution of the parent's board

Bill, which added this provision to the GCL, had not been introduced when this decision was rendered.

150. See notes 105-15 *supra* and accompanying text.

151. Gen'l Corp. Law, *supra* note 1, §§ 1312(b), (c) provide the minority shareholders of the subsidiary with additional remedies and rights to protect their interests. See text accompanying notes 225-40 *infra.*

152. *Id.* § 1110(d). If the disappearing corporation is a close corporation, *id.* § 158(a), but the surviving corporation is not, section 1111 requires that the merger be approved by the affirmative vote of at least two-thirds of each class of the outstanding shares of the disappearing corporation. However, the "articles . . . may provide for a lesser vote, but not less than a majority of the outstanding shareholders of each class." *Id.* § 1111. It is not entirely clear whether section 1111 is intended to require a formal vote by a close corporation subsidiary's shareholders and thus override section 1110(b) which dispenses with a formal shareholder vote on a short-form merger. Since in a short-form merger the parent corporation's ownership will by hypothesis exceed the vote specified in section 1111, a formal vote by the shareholders of the disappearing corporation would be superfluous. Accordingly, section 1111 should not be interpreted as overriding section 1110(b).

> shall provide for the merger, shall provide that the parent corporation assumes all of the liabilities of each subsidiary corporation and shall set forth the securities, cash, property or rights to be issued, paid, delivered or granted by the parent corporation upon surrender of each share of each subsidiary corporation not owned by the parent corporation.[153]

The resolution of the board of the subsidiary must approve the fairness of the consideration to be received for each share of the subsidiary not owned by the parent.[154]

The parent corporation may change its name as a part of the short-form merger.[155] This enables a corporation to employ this form of transaction to amend its articles for this limited purpose without approval of its shareholders. Unlike prior law, which only permitted the parent to adopt the name of the subsidiary in a short-form merger,[156]

153. *Id.* § 1110(b).

154. *Id.* Compare this requirement of action by the subsidiary's board with DEL. CODE ANN. tit. 8, § 253(a) (Supp. 1975), which imposes no responsibilities on the directors of the subsidiary. Professor Ernest Folk observes that in a Delaware short-form merger

> the directors of the subsidiary have nothing to do with the merger. Thus they need not obtain any impartial or independent appraisal of the value of the subsidiary's stock, and since they have no "rights" with respect to the merger, they have no duties to minority stockholders.

E. FOLK, THE DELAWARE GENERAL CORPORATION LAW—A COMMENTARY AND ANALYSIS 352 (1972) [hereinafter cited as FOLK]. The GCL is diametrically opposite to the Delaware code on this subject. The board of the subsidiary must approve the fairness of the price paid to the minority, and in this respect the directors obviously must discharge their duties as directors. *See* Gen'l Corp. Law, *supra* note 1, § 309. GCL section 310 contains a procedure for validating agreements and transactions between corporations with common directors or between a corporation and another corporation in which a director of the first has a material financial interest. Since it is distinctly possible that a director of a subsidiary in a short-form merger may also be a director or shareholder of the parent corporation, consideration should be given to the possible applicability of section 310 to a short-form merger. Section 310 appears to be aimed at assuring fairness to a corporate party in a transaction with an affiliate rather than fairness to the shareholders of the corporate party. This is supported by a comparison of the language of section 310 with section 1312(c) which deals with the fairness of a business combination involving affiliates to the shareholders affected by the affiliation. Section 1312(c) inquires into whether the "transaction is just and reasonable as to the shareholders of the controlled party," whereas subdivisions (a) and (b) of section 310 require that the transaction be "just and reasonable as to the corporation." For these reasons, it would appear that section 310 should not be applied to the action of directors of a subsidiary approving a short-form merger. However, section 310(b) *would* apply to action by the board of the parent corporation if any member of that board is also a director of the subsidiary. Additionally, section 310(a) would apply if any parent director had a material financial interest in the subsidiary.

155. Gen'l Corp. Law, *supra* note 1, § 1110(c).

156. CAL. CORP. CODE ANN. § 4124 (West Supp. 1975).

the GCL permits the parent to take any corporate name, including the name of the subsidiary or a similar name. This right, of course, is qualified by the requirement that there be adherence to the provision designed to prevent the adoption of misleading corporate names. If a change in corporate name is to be accomplished, the resolution adopted by the board of the parent must establish the wording of the amendment in compliance with the requirements applicable to certificates of amendment.[157]

The short-form merger and any associated name change becomes effective upon the filing with the Secretary of State of a certificate of ownership of the parent corporation together with a copy of this certificate for each disappearing corporation.[158] The delayed effectiveness of filing provisions of the GCL discussed earlier[159] are also applicable to the effectiveness of short-form mergers. As in the case of a filing to accomplish a merger reorganization, a precondition to filing the certificate of ownership is the filing of a franchise tax clearance certificate issued by the Franchise Tax Board for each disappearing subsidiary.[160]

The short-form merger may be utilized by a domestic parent corporation to effect a merger of either a domestic subsidiary or a subsidiary incorporated in a state whose laws permit this type of transaction.[161] The parent corporation may also be a foreign corporation organized under laws that permit short-form mergers of the type authorized by the GCL, provided that at least one of the subsidiaries is a domestic corporation.[162] But in such a case the only filing required is a certificate of ownership for each disappearing domestic subsidiary and each

157. Gen'l Corp. Law, *supra* note 1, § 1110(c). The last paragraph of section 905 provides that the filing of a certificate of ownership pursuant to section 1110(d) will satisfy the filing requirements for effecting the amendment to articles to change the corporate name of the parent corporation.

158. *Id.* § 1110(f). The required officers' certificate must

> (1) Identify the parent and subsidiary corporation or corporations.
> (2) Set forth the share ownership by the parent corporation of each subsidiary corporation as 100% . . . or as at least 90% of the outstanding shares of each class . . . .
> (3) Set forth the resolution adopted by the board of the parent corporation, including the resolution for change of name if applicable.
> (4) Set forth the resolution adopted by the board of each subsidiary corporation, if required.

Id. § 1110(d).

159. See text accompanying notes 125-28 *supra.*

160. Gen'l Corp. Law, *supra* note 1, § 1110(e). Of course the tax clearance requirement only applies to subsidiaries that are subject to the Bank and Corporation Tax Law. *Id.*

161. *Id.* §§ 1110(a), (b), (h).

162. *Id.* § 1110(g).

foreign subsidiary qualified to transact intrastate business in California.[163]

If there were any minority shareholders of a subsidiary immediately prior to the effective date of the short-form merger, the surviving corporation must, within ten days *prior* to the effective date of the merger, give written notice to these shareholders that the merger will become effective on or after a specified date.[164] This notice must include copies of the resolutions adopted by the boards of the parent and subsidiary, and information designed to apprise the shareholders of their rights as dissenters, the procedure for asserting these rights, and the price the parent has determined represents the fair market value of their shares.[165] The minority shareholders are given the same dissenters' rights as are accorded to shareholder groups entitled to vote on reorganizations.[166]

Since the adoption of the GCL and its short-form merger provision, the decision of the Second Circuit Court of Appeals in *Green v. Santa Fe Industries, Inc.*[167] has cast doubt on the use of state short-form

163. *Id.*

164. *Id.* § 1110(i). At the time of its adoption section 1110(i) only required that notice be given to minority shareholders within ten days *after* the effective date of the merger. However, since the adoption of the GCL the Second Circuit Court of Appeals in Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2nd Cir.), *en banc rehearing denied*, 533 F.2d 1309 (1976), held that the use of the Delaware short-form merger statute, absent notice to the minority and absent a justifiable business purpose, constituted a violation of rule 10b-5 and section 10(b). Judge Medina reasoned that federal courts are in part justified in finding a violation of federal law where minority shareholders have not received prior notice of a merger and, therefore, are unable to seek pre-merger injunctive relief. To meet this objection the Technical Amendments Bill modified section 1110(i) to require that notice of a short-form merger be given to the minority shareholders at least ten days *before* the effective date of the merger. The *Green v. Santa Fe Indus.* case is discussed further in the text accompanying notes 167-81 *infra.*

165. Gen'l Corp. Law, *supra* note 1, § 1110(i).

166. *Id. See id.* § 1300(a).

167. 533 F.2d 1283 (2nd Cir.), *en banc rehearing denied*, 533 F.2d 1309 (1976). Rehearing was denied for the same reason given in *Marshel v. AFW Fabric Corp.* See note 117 *supra* for the court's reason for denying an en banc rehearing. In *Green*, Forest Products, a wholly-owned subsidiary of Santa Fe Resources, merged into Kirby Lumber which was ninety-five percent owned by Santa Fe Resources. The merger was effected in accordance with the Delaware short-form merger statute which, unlike the GCL, permits either the parent or the subsidiary to be the surviving corporation in a short-form merger. 533 F.2d at 1288. The merger resolution adopted by Forest Products provided that the minority stockholders of Kirby would receive $150 per share in cash for their Kirby shares or could seek appraisal of their shares under the Delaware dissenters' rights statutes. After the merger was completed, notice of the merger and a financial information statement about Kirby were sent to the minority shareholders The

merger procedures.[168] Writing for the court, Judge Medina reasoned

information statement included an opinion of an investment banking firm to the effect that if publicly traded, Kirby shares would trade at approximately $125 per share. The information statement also contained the opinion of an appraisal firm valuing Kirby's land and timber at $320 million. *Id.*

The plaintiffs, minority stockholders of Kirby, sought to have the merger rescinded and money damages awarded because the minority shares were acquired by Santa Fe at a grossly undervalued price. They alleged that on the basis of the appraisal report included in the information statement the Kirby shares were worth at least $772 per share. The plaintiffs also alleged that this undervaluation, coupled with Santa Fe's failure to disclose the merger to plaintiffs until after it was completed and the fact that the merger was effected without any business purpose, constituted a violation of section 10(b) and rule 10b-5. *Id.*

The district court granted defendants' motion to dismiss the complaint, primarily on the ground that the facts alleged did not constitute a violation of rule 10b-5. Green v. Santa Fe Indus., Inc., 391 F. Supp. 849 (S.D.N.Y. 1975). Quoting with approval from the principal Delaware decision on whether there must be a business purpose for a short-form merger, the district court concluded that a business purpose is not required and that lack of such a purpose would not violate rule 10b-5 in the absence of any allegation of misrepresentation or lack of disclosure. The decision was Stauffer v. Standard Brands, Inc., 178 A.2d 311 (Del. Ch. 1962), and the language quoted by the district court from this decision appears in note 168 *infra.*

The court of appeals reversed the district court in a decision with three separate opinions, the opinion of the court, a concurring opinion and a dissenting opinion. The court reserved judgment on whether a charge of an excessively low valuation by itself would allege a violation of rule 10b-5. 533 F.2d at 1291.

168. Before *Green v. Santa Fe Indus., Inc.* state court decisions had uniformly accepted short-form mergers as statutorily sanctioned methods of eliminating unwanted minority interests, and rejected any notion that some business purpose beyond elimination must be shown. *See, e.g.*, Stauffer v. Standard Brands, Inc., 178 A.2d 311 (Del. Ch.), *aff'd*, 187 A.2d 78 (Del. 1962); Rank Organ. Ltd. v. Pathe Laboratories, Inc., 227 N.Y.S.2d 562 (1962); *cf.* Teschner v. Chicago Title & Trust Co., 322 N.E.2d 54 (Ill. 1974). In *Stauffer v. Standard Brands, Inc.*, the Delaware Supreme Court rejected an attack on a short-form merger based upon breach of fiduciary duty by stating that

> the very purpose of the [Delaware] statute is to provide the parent corporation with a means of eliminating the minority shareholder's interest in the enterprise.

187 A.2d at 80. Using *Stauffer* and other authority, the district court in *Green* took the view that

> [t]he Delaware corporation law does not require that the merger be effected for a business purpose. The statute reflects the public policy of Delaware with respect to rights or splinter rights in corporations.

391 F. Supp. at 852. Contrary results are urged in VORENBERG, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964) and Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630 (1961). These contrary views were expressly considered and rejected by the Illinois Supreme Court in Teschner v. Chicago Title & Trust Co., 322 N.E.2d 54, 57 (Ill. 1974). *But cf.* Jutkowitz v. Bourns, Los Angeles Super. Ct. Case No. CA000268 Memorandum of Decision (Nov. 19, 1975), which is discussed in note 149 *supra.*

The federal court decisions prior to *Green* were inconsistent although only one (aside from the lower court opinion in *Green* at 391 F. Supp. 849 (S.D.N.Y. 1975)) actually dealt with a short-form merger. The only court of appeals decision was the Fifth

that use by the majority of corporate funds in a short-form merger for the sole purpose of eliminating the minority shareholders' interests in the corporation was a breach of the majority's fiduciary duty to the minority and that this breach constituted a fraud on the minority.[169]

If *Green* becomes the law of the Ninth Circuit, the GCL short-form merger provision will be useless in its application to subsidiaries with minority interests. In evaluating whether this will in fact occur, it is important to compare the GCL with the Delaware statutes in light of the rationale of *Green*. First, Judge Medina noted that the sole remedy of the plaintiffs under Delaware law was under the appraisal statutes.[170] Additionally, Judge Mansfield in his concurring opinion observed that an appraisal remedy was inadequate when compared with federal relief.[171] This would not be the case under the GCL because dissenters' rights are not made the exclusive remedy in any reorganization or short-form merger involving affiliated parties.[172] So long as a shareholder

Circuit's opinion in Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974). This case involved a regular statutory merger with the minority receiving cash for their shares, and alleged violations of rule 10b-5. The court concluded that compliance with the state statutory merger procedure would not be sufficient if the transaction had no business purpose other than to eliminate the interest of one shareholder. However, the case was disposed of solely on state law grounds. *Bryan* was distinguished in Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393 (N.D. Fla. 1974), in which the court found a business purpose for a minority cash-out merger between a parent and a fifty-seven percent owned subsidiary. The purposes advanced by the defendants and accepted by the court included cost savings from the elimination of duplicate expenses (salaries, legal and accounting fees, stock transfer fees, public relations expenses, directors' fees, and franchise taxes) and the elimination of the inhibiting effect of potential claims of conflict of interest in transactions between the parent and the subsidiary.

In Levine v. Biddle Sawyer Corp., 383 F. Supp. 618 (S.D.N.Y. 1974), the district court concluded that a complaint by a minority shareholder whose interest was eliminated in a Delaware short-form merger stated a claim under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. The complaint alleged that over a period of a year certain defendants engaged in a scheme of deceit and concealment for the purpose of squeezing out the plaintiff and obtaining his shares at less than their true value.

169. The court concluded:

> We hold that a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose. The minority shareholders are given no prior notice of the merger, thus having no opportunity to apply for injunctive relief, and the proposed price to be paid is substantially lower than its appraised value reflected in the Information Statements.

533 F.2d at 1291.

170. *Id.* at 1286.

171. *Id.* at 1297.

172. Gen'l Corp. Law, *supra* note 1, § 1312(b). See discussion in text at notes 226-29 *infra*.

does not elect to perfect his dissenters' rights he will not be precluded from seeking legal or equitable relief for damage claimed to have resulted from a short-form merger.

Second, the plaintiffs and the court in *Green* made much of the fact that the short-form merger was completed without prior notice to the minority stockholders who were thereby precluded from obtaining a pre-merger injunction to halt the combination.[173] Unlike the Delaware statute, the GCL requires that the minority shareholders be given at least ten days notice prior to the effective date of the merger.[174] Thus, premerger injunctive relief will be available in appropriate cases. However, it should be noted that the GCL does place limits on enjoining the consummation of a business combination. These limitations require that such an injunction may only be granted on ten days prior notice to the corporation and only if the court determines that clearly no other remedy will adequately protect the complaining shareholder or the class he represents.[175]

Third, both Judge Medina[176] and Judge Mansfield[177] were critical of the tenor of Delaware's corporation statutes and particularly about the ease with which these statutes could be employed to squeeze out minority shareholders. In contrast with Delaware law, the GCL establishes a comprehensive framework for the protection of minority shareholders in business combinations and thus reflects a firm state policy to restrict transactions that have a significant potential for overreaching by controlling shareholders. As discussed earlier, the equal treatment and common share exchange requirements effectively preclude discrimination against minority shareholders in merger reorganizations.[178] Moreover, in a short-form merger, the board of the subsidiary must approve the fairness of the consideration to be given to the minority shareholders. This feature is without parallel in Delaware law.[179]

The nonexclusivity of the appraisal remedy in all combinations involving affiliates will enable minority shareholders to maintain a class action to protect their interests. One of the major benefits of this procedural device was not available in Delaware state courts to the

173. 533 F.2d at 1292.

174 Gen'l Corp. Law, *supra* note 1, § 1110(i). See discussion in text at notes 164-65 *supra.*

175. Gen'l Corp. Law, *supra* note 1, § 1312(b). See discussion in text at note 229 *infra.*

176. 533 F.2d at 1289.

177. *Id.* at 1295.

178. See discussion in text at notes 105-15 *supra.*

179. See note 154 *supra* and accompanying text.

plaintiffs in *Green* because Delaware bars a shareholder who initiates an appraisal proceeding from receiving compensation from inactive dissenting shareholders.[180] Finally, the GCL requires that the parent corporation in a short-form merger, in any action to attack the merger or have it set aside, will have the burden of proving that the transaction is just and reasonable to the shareholders of the subsidiary.[181]

Will these procedural and substantive safeguards protect the GCL short-form merger from the result in *Green*? It is too soon to know. The Ninth Circuit or the United States Supreme Court could decide that any short-form merger statute is inherently fraudulent irrespective of safeguards and therefore violative of rule 10b-5. This would be an unfortunate result. State legislatures should be permitted to regulate the conduct of controlling shareholders, and this regulation must include the discretion to establish the standards for both permitted as well as prohibited conduct. Where a state has concluded that a procedure for the elimination of a ten percent minority interest, which contains reasonable protective features, is lawful, it is improper for a federal court to find fraud that is premised solely on its perception of the fairness of that procedure.

E. Dissenters' Rights

1. Introduction

The purpose of dissenters' rights provisions is to afford shareholders who disagree with a fundamental corporate change the opportunity to liquidate their investment at its fair market value as an alternative to being compelled to continue their interest in the changed enterprise. The prospect of dissenters' rights being asserted in a transaction may also have the incidental salutary effect of causing the terms of the transaction to be attractive enough to minimize the actual assertion of these rights. The dissenters' rights provisions may therefore be viewed as providing additional protection to shareholders against unfair business combinations.

180. *See* Raynor v. LTV Aerospace Corp., 317 A.2d 43 (Del. Ch. 1974); Levin v. Midland-Ross Corp., 194 A.2d 853 (Del. Ch. 1963). Both of these cases were cited in footnote 4 of Judge Mansfield's concurring opinion in *Green*. 533 F.2d at 1297-98 n.4.

181. *See* Gen'l Corp. Law, *supra* note 1, § 1312(c). In this connection, it should be noted that California courts have been appropriately sensitive to conduct by controlling persons that has disadvantaged minority shareholders. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969); Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 38 Cal. Rptr. 148 (1964); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

Under prior law, dissenters' rights were only applicable to statutory merger or consolidation transactions, and any shareholder of any constituent corporation could assert these rights by following the statutory procedure.[182] In contrast with prior law, the GCL extends dissenters' rights to all forms of reorganization, but only shareholders of the corporate party or parties whose shareholders must approve the reorganization are given these rights.[183] This means that the protection afforded by these rights generally will be available only to shareholder groups whose prospective ownership in the combined continuing enterprise will represent five-sixths or less of the total combined voting power of that enterprise. The GCL also extends dissenters' rights to the minority shareholders of the subsidiary in a short-form merger.[184]

The wisdom of denying dissenters' rights to shareholders because they do not suffer the specified level of dilution of voting power can of course be debated. Yet it seems logical that these rights apply only to shareholders whose interests have been affected in a significant respect. The use of voting power dilution as the measure of significance has two advantages. First, it may be easily ascertained with a minimum degree of subjectivity. Second, it is a rational method of evaluating the impact of a business combination on a shareholder of a corporate party. The issuance of voting securities affects a shareholder's ability to influence fundamental corporate decisions, and voting power dilution is a method of measuring the reduction in this influence. Voting power dilution may also be a rough approximation of the degree to which the combination will affect the business of the continuing enterprise.

2. Scope of Coverage

Dissenters' rights involve the right to require the corporation to purchase for cash, at fair market value, shares issued by it that are "dissenting shares" within the meaning of section 1300(b).[185] These rights do not apply to shares, such as certain preferred shares, whose terms and provisions specifically set forth the amount to be paid in respect of these shares upon the occurrence of a reorganization or merger.[186]

182. CAL. CORP. CODE ANN. § 4300 (West Supp. 1975).

183. Gen'l Corp. Law, *supra* note 1, § 1300(a).

184. *Id.* See *id.* § 1110(i). These provisions actually extend dissenters' rights to any shareholder of the subsidiary, but for obvious reasons these rights are only available to the minority shareholders of the subsidiary.

185. *Id.* § 1300(a).

186. *Id.* § 1311.

Section 1300(a) provides dissenters' rights in each of the following circumstances: (1) in a reorganization, to each of the shareholders of a corporation if approval of the outstanding shares of that corporation is required under subdivisions (a) and (b) of section 1201; (2) in a reorganization, to each of the shareholders of a close corporation if the holders of any class of shares of that corporation will receive shares in a corporation that is not a close corporation; and (3) in a short-form merger, to the minority shareholders of the disappearing subsidiary. In a case where subdivisions (a) and (b) of section 1201 require approval by shareholders of a corporation, section 1300(a) gives dissenters' rights to all shareholders, even those who are not given a right to vote on the reorganization.[187]

Dissenters' rights are generally thought of as giving a shareholder the choice between accepting shares or other equity securities on the one hand or cash on the other. However, the GCL also extends dissenters' rights to transactions in which the dissenting shareholders will have to choose between accepting a specified price payable in cash or debt securities and pursuing his remedies as a dissenting shareholder. For example, cash is often given to the minority shareholders in a short-form merger; and a sale-of-assets reorganization may involve the issuance of debt securities.[188]

The apparent purpose of treating an acquisition of assets in exchange for nonconvertible, unsecured debt securities as a reorganization was to give dissenters' rights protection to the shareholders of the selling corporation. If the debt securities are convertible or are issued with warrants, the transaction will involve the issuance of equity securities[189] and therefore will be a sale-of-assets reorganization. If no equity securities are issued, there will be no reorganization unless the debt securities issued have a maturity in excess of five years from the consummation of the transaction and are not adequately secured.[190] The rationale for

187. *Id.* § 1300(a). The only shareholders who are denied a vote on a reorganization when other shareholders of the same corporation are given a vote are holders of certain non-voting preferred shares of the surviving or acquiring corporation or any parent party. *Id.* § 1201(a); see discussion in text at notes 45-48 *supra.* Although section 1300(a) clearly provides that the holders of these preferred shares will have dissenters' rights, this section also specifies that these rights only apply to "dissenting shares" as this term is defined in section 1300(b). Unfortunately, section 1300(b)(2) requires that in the case of certain marketable securities the shares must actually be voted against the reorganization in order to be dissenting shares. See discussion in text at notes 205-06 *infra.* It appears, therefore, that the drafters of the GCL intentionally or inadvertently deprived the holders of certain non-voting marketable preferred shares of the safeguards of both voting and dissenters' rights.

188. *Id.* § 181(c).

189. *Id.* § 168.

190. *Id.* § 181(c). Where the acquiring corporation issues only "adequately se-

this distinction based upon term and security, while not entirely clear, appears to be that a shareholder needs more protection if he will receive a long-term payout where there is an appreciable risk of nonpayment because the payment obligation is inadequately secured.

3. Valuation of Dissenting Shares

Section 1300(a) provides that a holder of dissenting shares is entitled to receive in cash the fair market value of those shares.[191] Under prior law the fair market value was determined as of the day before the shareholder vote on the merger, but excluding any appreciation or depreciation resulting from the proposed combination.[192] However, it was often difficult if not impossible to determine whether appreciation or depreciation in market value occurring prior to the shareholder vote was attributable to the combination or other factors. For this reason the GCL pegs the valuation of dissenting shares to

> the day before the first announcement of the terms of the proposed reorganization or short-form merger, excluding any appreciation or depreciation in consequence of the proposed action, but adjusted for any stock split, reverse stock split or share dividend which becomes effective thereafter.[193]

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cured" or short-term debt securities, as to which repayment is presumably assured (*i.e.*, the equivalent of cash), the provisions of Chapters 12 and 13 are not applicable. Thus, the shareholder approval requirements of section 1001(a)(2) (majority non-class vote) rather than of section 1201(a) (majority class vote) will be applicable, and the recipients of this cash equivalent consideration will not be entitled to dissenters' rights. One might properly inquire whether a debt security with a five year maturity is in fact the equivalent of cash. Furthermore, the absence of a defintion of "adequately secured" in the GCL may cause such a degree of uncertainty that practitioners will be unwilling to rely upon the existence of security for debt securities to take a transaction out of the reorganization category.

191. *Id.* § 1300(a). There is a paucity of California authority on the meaning of fair market value for purposes of dissenters' rights. The one reported decision on this subject indicates that considerable weight should be given to the market price of actively traded shares. Gallois v. West End Chem. Co., 185 Cal. App. 2d 765, 8 Cal. Rptr. 596 (1960). This view is buttressed by the GCL's marketable securities exception to dissenters' rights. See text accompanying notes 198-206 *infra*. However, should the trading market price be the overriding consideration if there is substantial divergence between these values and underlying net asset values? In arriving at the fair market value of dissenting shares, Delaware authorities require that consideration be given to a number of factors including underlying asset values, earnings, market values, and dividends. For a discussion of these authorities, see FOLK, *supra* note 154, at 380-87.

192. CAL. CORP. CODE ANN. § 4300 (West Supp. 1975).

193. Gen'l Corp. Law, *supra* note 1, § 1300(a). The capital changes referred to in section 1300(a) are those effected by the corporation that is obligated to purchase the dissenting shares. Thus, a capital change by the surviving corporation or its parent party will not affect the valuation of dissenting shares of the acquired corporation in a merger reorganization. Section 1300(a) does not require an adjustment in the valuation of

The statute does not specify which of the terms of a reorganization must be included in an announcement in order to establish the valuation date. Surely only the essential terms would be required. These are probably the identities of the parties to the combination and a description of the amount and type of the consideration to be issued or paid for the assets or securities of the company to be acquired.[194] There is no requirement that the announcement that establishes the valuation date must formally emanate from any of the parties to the combination. Disclosure of the terms of a proposed reorganization in the *Wall Street Journal* as a result of an unauthorized leak of terms would appear to satisfy the terms of the statute. The only questions would be whether the unauthorized article contained the essential terms of the proposed transaction and possibly whether the parties had reached agreement on these terms at the time the article was published.[195] Even in the absence of a published announcement, premature leaks about combination negotiations may produce trading activities that will affect the value of shares for dissenters' rights purposes.[196]

On occasion it may be necessary to make a public announcement of the pendency of acquisition negotiations before there has been any agreement in principle on a combination. This will typically be done if there is unusual trading activity in the shares of one of the parties and it is believed that a leak about the negotiations may have occurred and may

dissenting shares for the payment of a cash or property dividend that occurs after the announcement. However, it would be logical to require such an adjustment, particularly in the case of an extraordinary distribution that significantly reduces the book or market value of the dissenting shares.

194. Query whether an announcement of revised terms requires a new valuation date. If the reorganization also involves a reclassification of or other share distribution on a class of shares of the surviving corporation or a parent party, the terms of this reclassification and distribution should also be in the announcement that establishes the valuation date of the affected shares.

195. If the parties have not reached an accord on the essential terms, technically the "terms of the proposed reorganization" do not exist. It is therefore arguable that a premature announcement in such a case does not identify the valuation date.

196. Rule 10b-5, *supra* note 103, creates disclosure requirements and limitations which will generally dictate that preliminary negotiations of a business combination be conducted confidentially. Premature disclosure can result in the dissemination of possibly misleading information since negotiations may not have progressed to the point where there is reasonable certainty that a transaction will occur on particular terms. In addition, leaks of information about combination negotiations can result in trading activity in which one party is acting on the basis of non-public information that is not available to the other party to the trade. If trading activities of the latter type affect the market prices of the shares of parties to the negotiations, they will also have a potential effect on the values of these securities for dissenters' rights purposes. Thus the importance of guarding against leaks is underscored by the GCL if the negotiations in fact lead to a reorganization.

have been responsible for this unusual activity. An announcement of this type ordinarily will, of necessity, be somewhat general in nature. Whether this will establish the valuation date will depend upon the contents of the announcement and the status of the negotiations. If in fact no accord has been reached, it would seem difficult for the announcement to contain or to be viewed as containing terms of the reorganization. Nevertheless, such an announcement will ordinarily draw attention to the shares of the named companies in the trading market, and may produce or be coincident with trading and changes in market values. If the later formal announcement of the terms of the combination is treated as the announcement contemplated by section 1300(a), the advantage of pegging the valuation date to precede public announcement may be lost. It may of course be argued that market changes following the earlier release should be disregarded because they were produced by the combination, but this requires the party asserting this proposition to prove the element of causation, which the announcement concept was designed to avoid.

4. The Marketable Securities Exception

As discussed earlier, the principal purpose of dissenters' rights is to assure a shareholder who dissents from a proposed fundamental change in his investment a choice between liquidating the investment at a fair cash price or accepting the changed investment.[197] This choice is normally available, even in the absence of dissenters' rights, to holders of shares for which an active trading market exists. In these cases dissenters' rights are not needed to provide a shareholder with a reasonable alternative to going along with a business combination to which he objects.

For these reasons section 1300(b)(1) of the GCL withdraws dissenters' rights from shares which immediately prior to a reorganization or short-form merger were either "listed on any national securities exchange certified by the Commissioner of Corporations . . . or listed on the list of OTC margin stocks issued by the Board of Governors of the Federal Reserve System . . . ."[198] The drafters of the GCL believed

197. See notes 182-84 *supra* and accompanying text.

198. Gen'l Corp. Law, *supra* note 1, § 1300(b)(1). These "listed" securities are referred to in the text as "marketable securities." Delaware law contains a similar exception to the dissenters' rights requirements for mergers and consolidations. DEL. CODE ANN. tit. 8, § 262(k) (1974). The Delaware marketable securities exception applies only to securities listed on any national securities exchange or held of record by at least 2,000 stockholders. *Id.* However, this exception does not apply to any shares of a constituent corporation if the holders of these shares are required by the merger to

that the trading markets in these securities would provide adequate liquidity to protect holders who oppose a combination. The national securities exchanges referred to are those that the Commissioner of Corporations has certified for the purpose of establishing the section 25100(o) exemption from qualification under the Corporate Securities Law of 1968.[199] At present, only the New York Stock Exchange and American Stock Exchange have been certified.

There are two circumstances which will nullify the marketable securities exception to dissenters' rights. They bear on whether the theoretical liquidity of these trading markets will in fact be available to a dissenter. The marketable securities exception will not apply to shares if they are subject to a restriction on transfer imposed by the issuer or any law or regulation.[200] Obviously the exception should not apply to particular shares that are in fact not marketable because of a restriction on transfer. However, this condition should be limited to a restriction that truly impinges on a holder's ability to sell at a fair value rather than one that establishes a procedure for sale. For example, if a holder can only sell shares in accordance with rule 144[201] of the Securities and Exchange Commission, this should not be viewed as a restriction if the holder can satisfy the conditions of this rule as to his entire position prior to the consummation of the reorganization.[202]

The second limitation on the marketable securities exception is that it has no application to shares of a class if dissenters' rights demands are filed with respect to at least five percent of the outstanding shares of that

accept as consideration for their shares anything *other than*: (1) shares of the surviving corporation (with or without cash for fractional shares), whether or not these shares are themselves listed or widely held; (2) shares of a corporation other than the survivor that are listed or widely held (with or without cash for fractional shares); or (3) a combination of (1) and (2). *Id.* Additionally, this section withdraws dissenters' rights from the shares of a surviving corporation if the merger can be accomplished without the vote of shareholders of that corporation by reason of § 251(f). *Id.* at 251(f) (Supp. 1795). See text accompanying note 50 *supra.*

199. CAL. CORP. CODE ANN. § 25100(o) (West Supp. 1976).

200. Gen'l Corp. Law, *supra* note 1, § 1300(b)(1).

201. 17 C.F.R. § 230.144 (1975). This rule was promulgated under the Securities Exchange Act of 1933, 15 U.S.C. § 77a *et seq.* (1970), *as amended,* 15 U.S.C.A. § 77a *et seq.* (Supp. 1976).

202. The fact that a Form 144 must be filed or an opinion letter delivered to the issuer and its transfer agent does not affect the holder's ability to realize a fair price. However, so long as the shares cannot be sold because of the quantity limitation or holding period requirements of rule 144, the shares are not marketable and should not be subject to the marketable securities exception. It should be noted that the restriction on transfer condition refers only to restrictions imposed by the issuer or laws or regulations. An agreement between a holder of shares and a third party restricting transfer, such as a pledge to secure a bank loan, would not fall within this condition.

class.[203] In such a case the sale or threatened sale of so many shares might depress the trading market for these shares, and dissenters' rights would be necessary to enable holders of this class to realize a fair price for their shares. There is a procedural condition to the marketable securities exception. Section 1300(b)(1) requires that the notice of meeting of shareholders to act on the reorganization must contain a summary of sections 1300-04, which define dissenters' rights and the required procedure for asserting these rights.[204]

5. Dissenting Shares

Dissenters' rights only apply to "dissenting shares" within the meaning of section 1300(b). This term refers to shares that meet all of the following requirements: (1) they are not subject to the marketable securities exception; (2) they must have been outstanding on the date for the determination of shareholders entitled to vote on the reorganization or, in the case of a short-form merger, must have been held of record on the effective date of that merger; and (3) the dissenting shareholder must have satisfied both the statutory demand and endorsement requirements with respect to these shares.[205]

Except in the case of marketable securities, dissenting shares also must not have been voted in favor of the reorganization.[206] However, if they are marketable securities then, without reference to the liquidity conditions that nullify the marketable securities exception, they must have been *voted against* the reorganization. The rationale for requiring

203. Gen'l Corp. Law, *supra* note 1, § 1300(b)(1).

204. *Id.* § 1300(b)(1). The GCL technically requires that these sections be summarized in the notice of meeting. In the case of a publicly held company, the notice of meeting is typically the cover page of a lengthy proxy statement which itself includes a description of the dissenters' rights procedure. Literal compliance with the requirement that the dissenters' rights provisions be summarized in the notice would entail expanding the length of the notice considerably or treating the entire proxy statement as the notice of the meeting. An alternative would be to include a prominent reference in the cover page notice to that part of the proxy statement in which the dissenters' rights procedure is discussed. Of course that discussion should include a summary of sections 1300-04 of the GCL, and typically the complete text of these provisions will appear as an exhibit to the proxy statement.

The obvious purpose of this requirement is to inform persons who may be entitled to these rights of the procedure and circumstances under which they may be asserted. This is particularly important because in order to perfect dissenters' rights for marketable securities, should it turn out that the exception is not applicable, they must be voted against the reorganization, *id.* § 1300(b)(2), and a written demand to purchase these shares must be received by the issuer or its transfer agent not later than the date of the meeting of shareholders to vote on the reorganization. *Id.* § 1301(b).

205. *Id.* § 1300(b).

206. *Id.* § 1300(b)(2)(i).

a vote against a reorganization in the case of publicly traded shares is to inform the issuer of the extent of the objections to the reorganization and, consequently, of its potential exposure to demands for cash. Under prior law, a publicly held issuer had no way of knowing which shares that were not voted in favor of a merger would ultimately become dissenting shares. This often necessitated more than a month's delay in consummating a merger after shareholder approval in order to ascertain whether actual dissenters' demands would exceed the limits specified in the agreement of merger as a condition of the combination. Under the GCL this delay can be avoided in the case of marketable securities. Nevertheless, where shareholder approval of a reorganization is sought by means of written consent rather than at a meeting of shareholders, dissenters' rights of holders of marketable securities can be perfected merely by not voting in favor of the reorganization. This exception for written consent is needed to protect any shareholder whose consent was not solicited.

6. The Dissenters' Rights Procedure

Section 1301(a) provides that if any shareholders of a corporation in a reorganization would have the right under section 1300 to require their shares to be purchased, the corporation must mail to its shareholders a notice that the reorganization has been approved by the shareholders. The notice must be mailed within ten days after the date of shareholder approval. It must contain

> a copy of Sections [1300-04], a statement of the price determined by the corporation to represent the fair market value of dissenting shares, and a brief description of the procedure to be followed if a shareholder desires to exercise the shareholder's rights under such Sections.[207]

In the case of a short-form merger, section 1110(i) requires that a similar notice be given at least ten days before the merger to the shareholders of the disappearing subsidiary. Section 1301(a) also provides that the required statement of price constitutes an offer by the corporation to purchase dissenting shares at that price.

In order to exercise dissenters' rights, section 1301(b) requires that a shareholder demand in writing that the corporation purchase his shares for cash at their fair market value. The demand will not be effective if the shares to be purchased are marketable securities unless it is received by the corporation or its transfer agent by the date of the shareholders' meeting to vote on the reorganization. In the case of other shares, the

207. *Id.* § 1301(a).

demand will only be effective if received within thirty days after the date of the corporation's mailing of the section 1301(a) notice or, in the case of a short-form merger, the section 1110(i) notice.

Section 1301 (c) requires that the shareholder's demand state the number and class of shares held of record which the shareholder demands be purchased. The demand must also contain a statement of what the shareholder claims was the fair market value of these shares as of the day before the announcement of the terms of the reorganization or short-form merger.[208] As in the case of the statement of fair market value by the corporation required by sections 1301(a) and 1110(i), the shareholder's statement of fair market value constitutes an offer to sell his shares at this price. The shareholder's statement of value is a departure from prior law which required only that the shareholder request the corporation to state its view of the valuation of the dissenting shares.[209] The GCL puts both the dissenting shareholder and the corporation on a similar footing by requiring at the outset that each express its view of valuation to the other and thereby be committed to that valuation if it is accepted by the other party. The GCL is silent on whether the shareholder's offer of sale terminates the offer of purchase by the corporation and if not how long the shareholder may wait before accepting the purchase offer. Similarly, there is no express provision governing the time limit on the corporation's acceptance of the shareholder's offer of sale. Additionally, it is unclear whether the corporation may unilaterally accept and bind the shareholder to his statement of valuation but contest the status of his shares as "dissenting shares."[210]

If the corporation and a dissenting shareholder agree that the shares are dissenting shares and agree upon the price to be paid for these shares, section 1303 requires the corporation to make payment for these shares at the agreed upon price within thirty days after the agreement on

208. *Id.* § 1301(c).

209. CAL. CORP. CODE ANN. § 4301 (West 1955).

210. With certain exceptions, the remainder of the GCL dissenters' rights procedure is quite similar to prior law. Under section 1302 a shareholder must submit for endorsement the certificates representing the shares he demands that the corporation purchase. The endorsement requirement of the GCL is similar to the prior law requirement. CAL. CORP. CODE ANN. § 4302 (West 1955). The certificates must be submitted to the corporation or its transfer agent within thirty days after the date on which the section 1301(a) or section 1110(i) notice was mailed to the shareholders. The certificates will be stamped or endorsed with a statement that the shares are dissenting shares, or will be exchanged for new certificates of the same denominations containing the stamped or endorsed statement. Upon the registration of transfers of these shares the new certificates will bear the same statement and the name of the original dissenting shareholder. Gen'l Corp. Law, *supra* note 1, § 1302

price has been reached.[211] Upon surrender of the certificates representing the dissenting shares, the dissenting shareholder will be entitled to the agreed upon price together with interest at the legal rate from the date of the agreement. The dissenting shareholder and corporation may by agreement extend or shorten the time for the payment of the agreed upon price for the dissenting shares.

If the corporation denies that shares are dissenting shares or is unable to reach agreement with the shareholder as to the fair market value of these shares, section 1304(a) permits these issues to be resolved by the institution of judicial proceedings either by the dissenting shareholder or by any interested corporation. A complaint to institute these proceedings must be filed within six months after the date on which the section 1301(a) or section 1110(i) notice was mailed to the shareholder, but not thereafter.[212] If neither a corporation nor a dissenting shareholder files such a complaint or intervenes in a pending action by or against another dissenting shareholder during this six-month period, the holder's shares will lose their status as dissenting shares and he will no longer have the right to require the corporation to purchase them.[213] If any litigation is instituted to test the sufficiency or regularity of the votes of the shareholders in authorizing a reorganization, any judicial proceedings to resolve dissenters' rights issues will be suspended until a final determination of this litigation.[214]

In a judicial action involving the resolution of dissenters' rights issues, two or more dissenting shareholders may join as plaintiffs or be joined as defendants and two or more of these actions may be consolidated into one action.[215] If the status of shares as dissenting shares is in issue, the court first will determine that issue and then determine the fair market value of dissenting shares if valuation is in issue.[216] Valuation will either be determined by the court directly or the court will appoint one

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211. This requirement is similar to prior law. *See* CAL. CORP. CODE ANN. §§ 4304-05 (West 1955).

212. Gen'l Corp. Law, *supra* note 1, § 1304(a). This is almost identical in substance to prior law. *See* CAL. CORP. CODE ANN. § 4306(c) (West 1955).

213. Gen'l Corp. Law, *supra* note 1, § 1309(c). This is almost identical in substance to prior law. *See* CAL. CORP. CODE ANN. § 4316(c) (West 1955).

214. Gen'l Corp. Law, *supra* note 1, § 1310. This is almost identical in substance to prior law. *See* CAL. CORP. CODE ANN. § 4317 (West 1955).

215. Gen'l Corp. Law, *supra* note 1, § 1304(b). This is identical to CAL. CORP. CODE ANN. § 4307 (West 1955).

216. Gen'l Corp. Law, *supra* note 1, § 1304(c). *Cf.* CAL. CORP. CODE ANN. § 4308 (West 1955).

or more impartial appraisers to determine the fair market value of the shares.[217]

Under section 1305(e) the court is empowered to assess or apportion the costs of the action against or among the parties to the proceeding as the court considers equitable. However, if the value awarded by the court is more than 125 percent of the price offered by the corporation, the court may require the corporation to pay not only the costs of the proceeding, but also the dissenting shareholder's attorneys' fees, fees of expert witnesses, and interest on the purchase price.[218] This is a new requirement and will probably put additional pressure on corporations to reach agreement with dissenting shareholders as to the fair market value of dissenting shares.

Section 1309 provides that dissenting shares lose their status as dissenting shares and the holders cease to be dissenting shareholders and will not be entitled to require the corporation to purchase their shares in any of the following circumstances: (1) the corporation abandons the reorganization; (2) the shares are transferred prior to their submission for endorsement or are surrendered for conversion into shares of another class in accordance with the articles; (3) judicial proceedings to resolve dissenters' rights issues are not commenced within the six-month period

217. Gen'l Corp. Law, *supra* note 1, § 1304(c). Prior law section 4308 required the court to appoint three appraisers. CAL. CORP. CODE ANN. § 4308 (West 1955).

The report of appraisers will be filed with the clerk of the court, and "on the motion of any party, the report will be submitted to the court and considered on such evidence as the court considers relevant." Gen'l Corp. Law, *supra* note 1, § 1305(a). This section is substantially identical to prior law. *See* CAL. CORP. CODE ANN. § 4309 (West 1955).

The court may confirm the report if it finds it to be reasonable. If the report is not confirmed or if a majority of the appraisers fail to make and file a report within the time allowed by the court, the court will determine the fair market value of the dissenting shares. Gen'l Corp. Law, *supra* note 1, § 1305(b). This section also is substantially identical to prior law. *See* CAL. CORP. CODE ANN. § 4310 (West 1955).

A judgment will be rendered against the corporation for payment of the fair market value of the dissenting shares of any dissenting shareholder who is a party to the action or who has intervened. This judgment together with interest at the legal rate from the date on which it was entered will be payable only upon the endorsement and delivery to the corporation of the certificates for the shares described in the judgment. Gen'l Corp. Law, *supra* note 1, §§ 1305(c), (d). Subdivision (c) is almost identical to prior law, but is qualified by reference to section 1306, which specifies the effect on the dissenters' rights obligation of the GCL's restrictions on a corporation purchasing its own shares. *See* CAL. CORP. CODE ANN. § 4311 (West 1955). Subdivision (d) is identical to prior law. *See id.* § 4312.

218. *Compare* Gen'l Corp. Law, *supra* note 1, § 1305(e) *with* CAL. CORP. CODE ANN. § 4313 (West 1955), which mandated that the corporation pay the costs of the action if the appraisal exceeded the price offered by the corporation.

required by section 1304; or (4) with the consent of the corporation the dissenting shareholder withdraws his demand for the purchase of dissenting shares.

7. Limitations on the Purchase of Dissenting Shares

Under prior law a corporation is permitted to purchase dissenting shares out of stated capital or out of any surplus, subject to the qualification that such a payment is prohibited in any case where there is reasonable grounds for believing that after the purchase the corporation will be unable to satisfy its debts and liabilities when they fall due.[219] The GCL qualifies a corporation's obligation to make payment for dissenting shares, whether that obligation is created by agreement or by a judgment rendered against the corporation, by the requirement that payments may only be made to the extent that they would not be prohibited by the provisions of Chapter 5 of the GCL, which establishes limitations on corporate distributions to shareholders.[220] By virtue of section 508, Chapter 5 does not apply to distributions by a corporation that has elected to wind up and dissolve. Accordingly, the selling corporation in a sale-of-assets reorganization will be permitted to make payments for dissenting shares, provided that all known debts and liabilities of the corporation have either been paid or adequate provision for payment has been made.[221] Section 1306 provides that to the extent that these limitations prevent the payment of the fair market value to any holder of dissenting shares, these holders become creditors of the corporation in the amount owed them for their dissenting shares together with interest at the legal rate until the date of payment. Furthermore, these debts are subordinate to all other creditors of the corporation in any liquidation proceeding and are payable when permissible under the provisions of Chapter 5.

219. CAL. CORP. CODE ANN. §§ 1706(d), 1708 (West 1955).

220. Section 166 defines "distribution to its shareholders" as including "the transfer of cash . . . by a corporation to its shareholders . . . or the purchase or redemption of its shares for cash . . . ." Gen'l Corp. Law, *supra* note 1, § 166. Section 500 prohibits a corporation from making a distribution to its shareholders unless either the retained earnings of the corporation equal or exceed the amount of the distribution or certain quantitative solvency and liquidity requirements are satisfied. *Id.* § 500. Distributions to shareholders are also prohibited if the corporation making the distribution is or would thereby be unlikely to meet its liabilities as they mature. *Id.* § 501. For a summary description of those limitations, see Barton, *A Brief Look at the New General Corporation Law*, 51 L.A.B.J. 210, 212-13 (1975); Dreyfuss, *Distributions to Shareholders Under the New California General Corporation Law*, 9 LOY. L.A.L. REV. 839, 849-56 (1976).

221. Gen'l Corp. Law, *supra* note 1, § 2004. For a discussion of this subject, see notes 261-64 *infra* and accompanying text.

Although section 1300(a) imposes upon the issuer the obligation to purchase dissenting shares, in many instances the issuer will not be in existence when payment for dissenting shares will be made. This will occur when the obligated company is a disappearing corporation in a merger.[222] In such a case, the obligation to pay for dissenting shares of the disappearing corporation will fall upon the surviving corporation by virtue of section 1107(a). In these cases, whether a payment for dissenting shares would be prohibited by the provisions of Chapter 5 will be determined by the application of those provisions to the surviving corporation, rather than to the corporation that originally incurred the obligation to make these payments.[223]

In addition to the limitations on dissenters' rights purchases imposed by Chapter 5, tax and accounting considerations will affect a corporation's ability to satisfy dissenters' rights demands.[224]

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222. Although it is theoretically possible for the acquiring corporation in a sale-of-assets reorganization to assume the obligation of the selling corporation to make payments for dissenting shares, this will ordinarily make it difficult, if not impossible, for the transaction to satisfy the "solely for voting stock" test for a type C tax reorganization. *See* note 224 *infra.*

223. Since the surviving corporation is in effect purchasing the dissenting shares of the disappearing corporation rather than its own, it is arguable that this is not a "distribution to shareholders" within the meaning of section 166. If this is the case, then Chapter 5 will not affect the survivor's ability to make payments for these dissenting shares. *See* Gen'l Corp. Law, *supra* note 1, at §§ 166, 500-03. However, section 1107 (a) provides that the surviving corporation succeeds to the liabilities of the disappearing corporation as if they had been incurred by the survivor. Furthermore, section 1107(b) states that the rights of the creditors of the disappearing corporation are preserved unimpaired. These provisions may be fairly interpreted to mean that the survivor is subject to the same restrictions, which are for the benefit of the creditors of the disappearing corporation, that were applicable to the disappearing corporation. The more reasonable construction of the GCL appears to require the application of Chapter 5 to these purchases.

The accounting treatment given to the combination by the surviving or acquiring corporation may affect its ability to pay for dissenting shares. This treatment will determine the values at which the acquired corporation's assets will be carried on the books of the surviving or acquiring corporation, the retained earnings account of the surviving or acquiring corporation, and the historical operating results of this corporation. *See* text accompanying notes 310-25 *infra.* These factors will in turn affect the corporation's ability to satisfy the income statement and balance sheet tests imposed on shareholder distributions by the GCL. Gen'l Corp. Law, *supra* note 1, §§ 500, 502-03; *see id.* § 114.

224. The extension of dissenters' rights to all forms of business combinations involving the issuance of equity securities may have an impact upon the characterization of certain of these transactions as tax-free reorganizations for federal income tax purposes. *See* INT. REV. CODE OF 1954, §§ 368(a)(1)(A)-(C). More specifically, the exercise of dissenters' rights by shareholders of the acquired corporation may interfere with such characterization in the following respects: (1) the acquisition by shareholders of the acquired corporation of a sufficient equity interest in the acquiring corporation in

8. Dissenters' Rights as an Exclusive Remedy

Both prior law and section 1312(a) provide that a shareholder entitled to dissenters' rights will not be permitted to attack the validity of a combination or to have it rescinded or set aside.[225] This concept of dissenters' rights as an exclusive remedy under prior law has received judicial approval.[226] The one express qualification to this principle under the GCL, which also appears in prior law, is that it does not preclude an action to test whether the reorganization has received the requisite shareholder approval.

Section 1312(b) introduces a new qualification to the concept that dissenters' rights are exclusive. This concept is not applicable to a reorganization or short-form merger where one of the parties is controlled by or under common control with another party to the transaction.[227] Dissenters' rights are thus not the exclusive remedy of a shareholder of a controlled corporation unless he elects this remedy. As a consequence of section 1312(b) such a shareholder will not be precluded from attacking the validity of a combination that has received the requisite shareholder approval. This is consistent with the trend of California authorities which permit, if not encourage, a court to review corporate transactions involving affiliates for their overall

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order to satisfy the judicially imposed "continuity of interest" doctrine; (2) the acquisition by the acquiring corporation of sufficient assets of the acquired corporation in order to satisfy the requirement that "substantially all of the properties" be acquired in a reorganization characterized under INT. REV CODE OF 1954, § 368(a)(1)(C); and (3) the transfer to the acquired corporation by the acquiring corporation of no consideration other than its voting stock in order to satisfy the requirement that an acquisition characterized as a reorganization under section 368(a)(1)(C) of the INT. REV. CODE OF 1954 be "solely for voting stock." *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶ 14.01-.57 (3d ed. 1971); Kringel, *Preventing a Dissenting Stockholder from Destroying a Tax-Free Reorganization*, 31 J. TAX. 138-42 (1969).

See note 223 *supra* and text accompanying notes 310-25 *infra* for a discussion of the effect of dissenters' rights on the accounting treatment given a business combination.

225. CAL. CORP. CODE ANN. § 4123 (West 1955).

226. Beechwood Sec. Corp. v. Associated Oil Co., 104 F.2d 537 (9th Cir. 1939); Giannini Controls Corp. v. Superior Court, 240 Cal. App. 2d 142, 49 Cal. Rptr. 643 (1966).

227. Gen'l Corp. Law, *supra* note 1, § 1312(b) provides that:

> If one of the parties to the reorganization or short-form merger is directly or indirectly controlled by, or under common control with, another party to the reorganization or merger, [the concept of exclusivity] shall not apply to any shareholder of such party who has not demanded payment in cash for such shareholder's shares pursuant to the [dissenters' rights provisions]; but if the shareholder institutes any action to attack the validity of the reorganization or short-form merger or to have the reorganization or short-form merger set aside or rescinded, the shareholder shall not thereafter have any right [to assert dissenters' rights].

fairness to the parties who may be disadvantaged by the affiliation.[228] The potential severity of this section is moderated by the requirement that in any action attacking the validity of a reorganization or short-form merger, the court may not restrain or enjoin the consummation of the transaction without giving ten days prior notice to the corporation and finding that it is clear that no other remedy will adequately protect the complaining shareholder or the class he represents.[229]

F. Additional Requirements and Considerations

1. Fairness and Combinations Involving Affiliated Parties

Although not a part of the dissenters' rights procedure, Chapter 13 of the GCL contains a provision which, like dissenters' rights, is designed to assure fair treatment to minority shareholders in business combinations by placing on the party in control the burden of proving that the transaction is just and reasonable as to the shareholders of the controlled party. This provision, section 1312(c), applies only to a reorganization or short-form merger where one party is directly or indirectly controlled by, or under common control with, another party.[230] The application of this provision to a business combination is dependent upon a control or common control relationship existing between parties to the combination. In this provision "control" means the possession of the direct or indirect power to direct or cause the direction of the management and policies of a corporation.[231] This is an amorphous concept. Controlling power can arise out of a variety of economic and personal relationships. Obvious economic relationships that may give

228. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

229. Gen'l Corp. Law, *supra* note 1, § 1312(b).

230. By definition the parent will control a merging subsidiary in any short-form merger. *See* Gen'l Corp. Law, *supra* note 1, §§ 160(a), 1110(b). In such a transaction, section 1312(c) requires that in any action to attack the validity of the reorganization or short-form merger or to have it set aside or rescinded

> (1) a party to a reorganization or short-form merger which controls another party to the reorganization or short-form merger shall have the burden of proving that the transaction is just and reasonable as to the shareholders of the controlled party, and (2) a person who controls two or more parties to a reorganization shall have the burden of proving that the transaction is just and reasonable as to the shareholders of any party so controlled.

Id. § 1312(c). Under Delaware law, the dominant corporation in a merger must carry the burden of establishing the fairness of the transaction. *See, e.g.*, David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 431 (Del. 1968); Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del.), *aff'g* 89 A.2d 862 (Del. 1952). The Delaware authorities on this point are well reviewed in FOLK, *supra* note 154, at 333-39.

231. Gen'l Corp. Law, *supra* note 1, § 160(a).

rise to control include those of shareholder and corporation, creditor and debtor, and supplier and customer. Familial and other interpersonal relationships can also create control influences which are very difficult to evaluate. Since it is not always easy to determine whether or not a control or common control relationship exists or to predict whether a court will conclude that it exists, section 1312(c) injects an element of uncertainty into some business combinations.

Section 1312(c) appears to be primarily a codification of the concept that in a transaction involving a controlling person and a controlled corporation, the controlling person must deal fairly with the controlled entity.[232] In any such transaction, the controlling person will be treated as a fiduciary to the controlled entity and to all of its shareholders. As a consequence, in any action in which the conduct of a controlling person vis-à-vis the corporation and its shareholders is called into question, the controlling person must justify the fairness of the transaction to all of the shareholders of the corporation.[233]

Section 310(a), the GCL's general rule of validation for transactions between corporations and directors and director affiliates, may also apply to a reorganization or short-form merger involving parties as to which a control or common control relationship exists.[234] This section deals with a transaction between two or more corporations in which a director of one has a material financial interest in the other.[235] It provides that this affiliation will not be a basis for attacking the transaction if any one of three specified procedures for validating the transaction is followed. The first procedure is the disclosure of all of the material facts as to the transaction and the director's interest to the shareholders of the corpora-

232. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); DeBaun v. First W. Bank & Trust Co., 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975); Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 38 Cal. Rptr. 148 (1964); *cf.* Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969).

233. *See, e.g.*, Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969); Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 38 Cal. Rptr. 148 (1964). *See also* Pepper v. Litton, 308 U.S. 295 (1939); Pearlman v. Feldman, 219 F.2d 173 (2d Cir. 1955). The concept of requiring an interested party to establish the fairness of a transaction with the corporation is an outgrowth of the adoption in 1931 of the predecessor to CAL. CORP. CODE ANN. § 820 (West 1955). Prior to 1931 the law absolutely prohibited any transaction between a director and his corporation. *See* H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 78.01 (4th ed. 1966).

234. See note 154 *infra* for a discussion of the application of Gen'l Corp. Law, *supra* note 1, § 310 to a short-form merger. *Id.* § 310(b) applies to transactions between corporations with one or more common directors but who have no material financial interest in either corporation.

235. Gen'l Corp. Law, *supra* note 1, § 310(a) provides that a mere common directorship does not constitute a material financial interest.

tion and approval by the shareholders of the transaction in good faith, with the shares owned by the interested director not being entitled to vote.[236] The second procedure is disclosure of the same facts to the board or a committee of the board and authorization, approval or ratification of the transaction by the board or such committee in good faith by a vote sufficient without counting the vote of the interested director or directors, provided that the transaction is also just and reasonable to the corporation at the time of its authorization, approval or ratification.[237] Third, the affiliation will not render the transaction void or voidable if the person asserting the validity of the transaction sustains the burden of proving that it was just and reasonable as to the corporation at the time it was authorized, approved or ratified.[238]

Section 1312(c) operates independently of section 310(a). Thus, use of either the first or second validation procedures established by section 310(a) will not affect the application of section 1312(c) to the transaction. However, the third method of validation and section 1312(c) are quite similar, and satisfaction of one may result in compliance with the other. The principal difference between the two is that section 310(a) refers to the fairness of the transaction to the *corporation* while section 1312(c) refers to the fairness of the transaction to the *shareholders* of the corporation.[239]

One unfortunate aspect of section 1312(c) is that it does not permit a validating procedure to avoid shifting the burden of establishing the fairness of a combination. A control or common control relationship between two parties to a reorganization may not be sufficient to assure the shareholder approval required by Chapter 12. Therefore, it would

236. *Id.* § 310(a)(1). "Approved by the shareholders" means generally approved by the affirmative vote of a majority of the shares entitled to vote represented at a meeting at which a quorum is present. *Id.* § 153.

237. *Id.* § 310(a)(2). An interested director may be counted in determining the presence of a quorum at a meeting of the board or a committee which authorizes, approves or ratifies a transaction in which that director is interested. *Id.* § 310(c).

238. *Id.* § 310(a)(3).

239. The distinction between these two concepts is not entirely clear. When will a combination be fair to a controlled party but not to the shareholders of that party? Perhaps an issuance of shares in an acquisition would not affect the fairness of the transaction to the issuer but would affect its shareholders. However, the acquisition of an unprofitable or marginally profitable business could directly affect the acquiring corporation's business as well as the interests of its shareholders. It is unlikely that a transaction will be fair to the shareholders of a corporation but not to the corporation itself. The distinction between fairness to shareholders and to the corporation is probably not an important one because in all likelihood a controlling party will have to justify that a transaction is just and reasonable to *both* the corporation and its shareholders.

seem unnecessary to require the burden to shift in any transaction approved by the shareholders of a controlled party or party under common control, so long as the control relationship is fully disclosed to the shareholders and the combination is approved by a sufficient shareholder vote without counting the shares held by the controlling party or person. Moreover, it would not be unreasonable to count the shares held by the controlling party or person if a majority or some higher proportion of the shares held by noncontrolling shareholders also approve the transaction.

Section 1312(b) contains a feature which may tend to reduce the likelihood of section 1312(c) being used as a basis for enjoining the consummation of a combination. An injunction or order prohibiting such a combination may not be issued without ten days prior notice to the corporation and in any case only if the court determines that it is clear that no other remedy will adequately protect the claimant or the class of shareholders of which he is a member.[240] This feature may in part counterbalance the possibly harsh result which can ensue from the operation of section 1312(c). Even a tenuously based assertion of unfairness can produce a costly settlement if it results in a temporary restraining order that blocks the closing of a combination where timing is critical. This statutory limitation on enjoining the consummation of combinations will tend to deter the type of attack that must depend upon extortionary circumstances rather than merit for its effectiveness.

2. Treatment of Fractional Share Interests

Whatever the form of a transaction, a business combination that involves the issuance of securities requires the allocation of these securities among the intended ultimate recipients. In the case of a merger or an exchange reorganization, the terms of the transaction will ordinarily specify an exchange ratio to accomplish this allocation. However, in a sale-of-assets reorganization the terms will typically contain only the aggregate number of shares or units of securities to be issued without specifying the allocation of this consideration among the security holders of the acquired corporation. As a part of the winding up and dissolution of this corporation, however, the securities received will be distributed among its shareholders.

Unless this allocation process results in an exchange ratio in which each recipient will receive a full share or shares for each share surren-

240. Gen'l Corp. Law, *supra* note 1, § 1312(b).

dered, fractional share interests will be produced. As in the case of prior law, the GCL permits the issuance of fractional shares, but this is rarely if ever done.[241] Section 407 specifies four methods for dealing with fractional interests in a business combination. First, arrangements may be made for those persons who are entitled to fractional shares to dispose of these interests.[242] This is usually accomplished by giving these persons the option of either selling their interest for cash or turning this interest into a full share by purchasing for cash a reciprocal fractional interest. To the extent possible these purchase and sale orders will be matched. If options to sell exceed the options to buy, the excess shares will ordinarily be sold in the open market. Conversely, if the purchases outbalance the sales, the excess will be satisfied by open market purchases. The issuing corporation can also deal with excess fractions by paying cash for fractions offered for sale or issuing additional shares to satisfy purchase offers.

The second method for dealing with fractional interests, and probably the least in current use, is the issuance of warrants or scrip that entitle the holder to receive a full share upon the surrender of warrants or scrip aggregating a full share.[243] These warrants or scrip do not truly evidence a fractional share because they generally do not carry voting or dividend rights, they do not participate in distributions upon liquidation of the issuing corporation, and they usually become void if they are not surrendered for a full share before a specified date.[244] This procedure is administratively cumbersome and its attendant cost ordinarily outweighs any benefits. For these reasons, as well as the ease of other accepted methods of disposing of fractional interests, the issuance of scrip and warrants is disfavored and seldom used.

The third and perhaps the most simple method of dealing with fractional interests is for the issuer to pay cash to the persons otherwise entitled to the fractional shares.[245] The payment must be the fair value

241. *See* Gen'l Corp. Law, *supra* note 1, § 407; CAL. CORP. CODE ANN. § 1113 (West Supp. 1975).

242. Gen'l Corp. Law, *supra* note 1, § 402(a).

243. *Id.* § 407(c).

244. Unlike prior law, all of these features of warrants and scrip are *expressly* authorized by section 407 of the GCL. However, this section also authorizes the board to grant dividend, voting and liquidation rights to the holders of scrip and warrants. As an alternative to providing for an expiration date for scrip or warrants, the board may require that they may be sold by the corporation and the proceeds distributed to the holders unless they are surrendered for a full share before a specified date.

245. Gen'l Corp. Law, *supra* note 1, § 407(b). These payments would of course be subject to the limitations on corporate share purchases contained in Chapter 5 of the

of the fraction of a share as of the time those entitled to receive fractions are determined. The determination by the issuer board of the fair value of a fractional share will be conclusive in the absence of fraud. Finally, the GCL permits fractions of a share in a merger or reorganization to be disregarded or in a merger to provide that the shares issuable will be rounded off to the nearest whole share.[246] This method of disposition is not available unless the fraction any person would otherwise be entitled to receive represents less than one-half of one percent of the total number of shares that person will receive in the transaction.

3. Winding Up and Dissolution

A sale-of-assets reorganization will typically be followed by a voluntary winding up and dissolution of the acquired corporation in order to facilitate the distribution to its shareholders of the securities received,[247] and because there is usually no longer any reason for the entity to remain in existence.[248] Section 1900(a) provides that the voluntary election to wind up and dissolve must be made by the vote of the holders of shares representing at least fifty percent of the voting power. This vote will ordinarily be taken at the time of any vote required for approval of the sale-of-assets reorganization. Typically these two matters are com-

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GCL. See note 220 *supra* for a brief discussion of these limitations. The GCL also prohibits the payment of cash for fractional shares if this would result in the cancellation of more than ten percent of the outstanding shares of any class. Gen'l Corp. Law, *supra* note 1, § 407. This prohibition is part of the GCL policy of preventing a cash squeeze-out of a greater than ten percent minority interest. A reverse stock split of enormous proportion can leave minority shareholders with only fractional share interests which could be eliminated by cash payment. In the absence of this limitation, the reverse split coupled with cash payments for fractional interests could be used to eliminate a minority interest that could not be eliminated in a merger under either sections 1101 or 1110.

246. Gen'l Corp. Law, *supra* note 1, §§ 1101, 1110.

247. The limitations on distributions to shareholders contained in Chapter 5 of the GCL, *id.* §§ 500-10, do not apply to proceedings for winding up and dissolution in accordance with either Chapter 18, *id.* §§ 1800-09 (involuntary proceedings), or Chapter 19, *id.* §§ 1900-07 (voluntary proceedings). *Id.* § 508. It may be impractical if not impossible to distribute the securities received in compliance with the limitations appearing in Chapter 5. Upon any failure to so comply, any director who approves a distribution of assets to shareholders that is contrary to the provisions of sections 500-03 risks both civil and criminal liability. *Id.* §§ 316(a)(1), 2253. See note 261 *infra* for a discussion of director responsibility in connection with distributions to shareholders in a proceeding for winding up and dissolution.

248. A sale-of-assets reorganization entails the sale of all or substantially all of a corporation's assets. Gen'l Corp. Law, *supra* note 1, § 181(c). Accordingly, after the sale there normally will not be any business to conduct or any other reason to remain in existence.

bined into a single proposition to be voted upon at a meeting of shareholders, since the approval of one but not the other is obviously pointless. The majority modified class vote required for approval of the reorganization will of course encompass the fifty percent non-class vote required for the election to wind up and dissolve. Naturally, the articles may provide for the vote of a greater proportion of the shares in order to make this election, may also grant a vote on this subject to shares that do not vote for directors, and may require the affirmative vote of one or more classes or series in order for the election to be made.[249]

Once the election has been made, a certificate of election must be filed with the Secretary of State.[250] Nevertheless, the election may be revoked before any distribution of assets to the shareholders by the vote of the holders of shares representing a majority of the voting power of the corporation.[251] This requirement for shareholder approval to revoke a voluntary election might produce complications if the reorganization is not consummated after the shareholder approval is given. Will additional shareholder action be required in such a case to revoke the election to wind up and dissolve? The answer to this question should be in the negative, but the provisions of the GCL do not readily indicate this result.[252] The clear intent of shareholder adoption of a voluntary

249. *Id.* § 204(a)(5).

250. *Id.* § 1901(a). The certificate must either be an officers' certificate, *id.* § 173, or must be signed and verified by at least a majority of the directors then in office or by a shareholder authorized to do so by shareholders holding the minimum number of shares required to approve the voluntary election to wind up and dissolve. *Id.* § 1901(b). In the case of an election incident to a sale-of-assets reorganization the certificate must set forth: (1) that the corporation has elected to wind up and dissolve, (2) the number of shares voting for the election and that the election was made by shareholders representing at least fifty percent of the voting power of the corporation, (3) if the certificate is executed by a shareholder, that the shareholder was authorized to do so by shareholders holding the requisite number of shares needed to approve the voluntary election. *Id.*

251. *Id.* § 1902(a). In the event of such a revocation a certificate evidencing the revocation must be signed, verified, and filed in the same manner as the certificate of election. *Id.* The requirements for the certificate of revocation appear in *id.* § 1902(b).

252. Voluntary proceedings for winding up commence with the adoption of the resolution of shareholders. *Id.* § 1903(a). When such a voluntary proceeding has commenced, the corporation must cease to carry on business except to the extent that this is necessary to preserve its good will or going-concern value pending sale of its business and assets. *Id.* § 1903(c). Notwithstanding the apparent finality of this provision, section 1201(f) states that the board may abandon a proposed reorganization without further action by shareholders. By implication this should permit the board alone to abandon a voluntary proceeding of dissolution that is obviously dependent upon and subsumed by the reorganization.

election as a part of approving a sale-of-assets reorganization is to discontinue the corporation's business and distribute its assets only if the reorganization is consummated. It would serve no useful purpose to require additional shareholder action to revoke the election if the reorganization is abandoned.[253]

Upon the making of the election, the corporation must cease doing business other than to the extent necessary to preserve its value pending completion of the sale.[254] During the period after the election the board continues to act as the board and has full power to wind up and settle the corporation's affairs.[255] The board must notify all shareholders who did not vote in favor of the election[256] and all known creditors and claimants[257] of the corporation of the commencement of the proceedings to wind up and dissolve. Although these proceedings are normally conducted by an officer or officers under supervision of the board,[258] upon petition by an appropriate person a court may take jurisdiction over the proceedings if it determines this is necessary for the protection of any party in interest.[259] A petition to institute judicial supervision of voluntary winding up and dissolution proceedings may be made by the corporation, one or more shareholders holding at least five percent of the shares of any class, any shareholder if the corporation is a close corporation, or any three or more creditors.[260]

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253. Prudence would dictate that the shareholder resolution approving the voluntary election specify that the election will not become effective unless and until the sale-of-assets reorganization is completed. In addition, the certificate of election should not be filed until the election becomes effective in accordance with this resolution.

254. Gen'l Corp. Law, *supra* note 1, § 1903(c).

255. *Id.* § 1903(b). This power continues even after the filing of the certificate of dissolution. *Id.* Section 2001 enumerates some of the powers and duties of directors and officers after commencement of dissolution proceedings.

256. *Id.* § 1903(c). This notice will probably be a part of the notice of approval of the reorganization by the shareholders which section 1301(a) requires must be sent to all shareholders if any shareholder would have dissenters' rights. *Id.* § 1301(a).

257. *Id.* § 1903(c). This section only requires notice to creditors whose addresses appear on the corporation's records. This notice will ordinarily take the form of a press release, letter or memorandum sent to customers, employees, suppliers, and other creditors, announcing completion of the reorganization. The announcement will be couched in terms of the business and assets of the corporation having been acquired by the acquiring company, which will continue this business and endeavor to maintain and foster the close business relationships of its predecessor. Somewhere in the public relations jargon will be a statement to the effect that the corporation has decided to wind up and dissolve and is going out of business.

258. *See* note 255 *supra* and accompanying text.

259. Gen'l Corp. Law, *supra* note 1, § 1904.

260. *Id.*

The securities received in the reorganization may only be distributed to the shareholders after the board has determined that all known debts and liabilities have been paid or adequate provision for payment has been made.[261] This requirement will typically be satisfied by having the acquiring corporation undertake to pay, perform, and discharge all of the debts and liabilities of the selling corporation.[262] If assets are distributed without a court order and without the required payment or provision, the corporation may recover any asset distributed to any shareholder of the corporation.[263] An action to recover assets improperly distributed may be brought in the name of the corporation by any creditor of the corporation, whether or not the creditor's claim has been reduced to judgment.[264]

261. *See id.* §§ 2004, 2009, 316(a)(2). Section 2004 states that the board must distribute the remaining corporate assets to its shareholders after it has made this determination. The conclusion that no distribution may be made without payment or adequate provision for all known debts and liabilities is based upon a reading of sections 2009 and 316(a)(2). Section 2009 permits creditors to recover from shareholders assets distributed in the absence of the required prior payment or adequate provision for payment, and section 316(a)(2) imposes civil liability on directors who approve such a distribution, subject to a showing that the directors acted in conformity with the standard of care imposed by section 309. Shareholders and directors may also incur responsibility for improper distributions under the Uniform Fraudulent Conveyance Act. CAL. CIV. CODE §§ 3439-3439.12 (West 1970).

262. Gen'l Corp. Law, *supra* note 1, § 2005. A practical problem occasionally will be created because the acquiring corporation will usually be unwilling to assume undisclosed liabilities of the selling corporation that are material in amount. How can the requirement for payment or adequate provision be satisfied in such a case? Two approaches have proved to be effective. In one approach the acquiring corporation will assume disclosed contingent claims and perhaps undisclosed claims if it receives adequate assurances that it will not suffer any loss if a claim should arise. The assurance may take the form of escrowing a portion of the shares to be issued or contractual indemnity from a financially responsible person, perhaps one or more large shareholders of the corporation being acquired.

The other approach is for the selling corporation to hold back from distribution to its shareholders a sufficient amount of the securities received to satisfy the known contingent liabilities. Additionally, there is a mechanism for depositing funds with a bank or the State Treasurer for the satisfaction of claims if the claimant is unknown or the existence or amount of the claim is contingent. *Id.* § 2008(a). The flexibility of this mechanism has been expanded over predecessor provisions of the prior law, which appear in CAL. CORP. CODE ANN. §§ 5010-11 (West Supp. 1975). For a discussion of the indemnity and escrow techniques, including some of the tax and accounting consequences of their use, see J. FREUND, ANATOMY OF A MERGER 365-70, 382-88 (1975). For a discussion as to whether and the extent to which the acquiring corporation can avoid assuming certain liabilities and obligations of the acquired corporation, see Orlanski, *The Avoidance of the Assumption of Liabilities in "Stock for Assets" Acquisitions*, 45 L.A.B. BULL. 361 (1970).

263. Gen'l Corp. Law, *supra* note 1, § 2009(a).

264. *Id.* § 2009(b). Prior law required the action to be brought by the corporation or by its receiver, liquidator or trustee in bankruptcy. CAL. CORP. CODE ANN. § 5012

Distribution of the securities received in a reorganization ordinarily poses no problem if the corporation has only outstanding common shares.[265] The terms of outstanding options, warrants, and convertible debt securities usually specify the disposition of these interests in the event of a sale of assets. The usual treatment of these interests is to have the acquiring corporation assume the issuer's obligations.[266] In the case of employee stock options, most plans under which these securities are issued provide that unexercised options will expire on the effective date of the reorganization unless the acquiring corporation assumes the issuer's obligation or provides a substitute option.[267]

If a corporation also has outstanding preferred shares, the distribution of the securities received may be somewhat more complicated. In some instances the terms of convertible preferred shares will provide in effect that the shares are treated as having been converted. This treatment is sometimes conditioned upon a majority or some higher percentage of this class or series of shares approving the reorganization. Distribution of the required securities may then proceed as if only one class of shares was outstanding. Alternatively, the terms of the preferred shares may specify a type of preferred share of an acquiring corporation that may be distributed in satisfaction of the liquidation preferences of these preferred shares. If the securities received in the reorganization include preferred shares that meet these requirements, distribution of the securities received will usually not pose a problem.[268]

(West 1955). This required creditors to institute proceedings for the appointment of a receiver, liquidator, or trustee rather than proceeding directly against the recipient of the wrongful distribution.

265. The GCL requires that all of the remaining assets of the corporation must be distributed among its shareholders according to their respective rights and preferences. Gen'l Corp. Law, *supra* note 1, § 2004. Unless the articles provide otherwise, assets will be distributed among the shareholders in the proportion that their respective shareholdings bear to the total of all shareholdings. *See id.* § 203.

266. The related trust indenture for convertible debt securities will often permit a sale-of-assets by the issuing corporation if the purchasing corporation executes a supplemental indenture or other contractual undertaking to assume the issuer's obligations, including the obligation to issue shares upon exercise of the conversion privilege. In some instances, usually in the case of privately placed debt securities, the indenture or purchase agreement will prohibit the sale-of-assets unless prior approval of a specified percentage of the outstanding principal amount of the debt securities is sought and obtained. Occasionally, the issuing corporation can nevertheless accomplish the reorganization by prepaying the debt securities, but in other cases the holders of these securities may be able to block the reorganization unless their demands are met.

267. These options usually permit exercise only in installments over a period of years of employment in order to provide an incentive for continuing service. In the event of a reorganization the installment feature is automatically waived to permit these options to be exercised in full.

268. This type of preferred share is very unusual because of the difficulty of

However, in many instances the satisfaction of liquidation preferences of outstanding preferred shares cannot be so neatly handled. In these cases the liquidation preference usually requires a cash payment before any distribution can be made to holders of junior shares. For tax and financial reasons cash payments in satisfaction of all of these preferences usually cannot be made.[269] Like prior law, the GCL contains a procedure to deal with liquidation preferences and the distribution of securities under these circumstances.[270] A distribution of assets which is not in accordance with the liquidation preferences of preferred shares may be made if provision for this is made in a plan of distribution adopted by the board and approved by a majority of the outstanding shares of each class regardless of any limitation or restriction on voting.[271] The plan may provide that the distribution is in complete or partial satisfaction of the rights of any class or series of shares upon distribution and liquidation of the assets.[272]

Within twenty days after adoption of a plan of distribution, notice of adoption must be given by mail to all holders of shares having liquidation preferences.[273] Once adopted the plan will be binding upon all shareholders, except that holders of shares with a liquidation preference who dissent from the plan may elect to receive a cash payment in the amount of the liquidation preference of their preferred shares.[274] This election must be made by filing a written demand within thirty days after the date the notice of adoption was mailed.[275]

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conceptualizing, at the time the original terms are being prepared, the type of security of an unknown issuer that would be acceptable in the future. Drafting such provisions, therefore, is often impractical if not impossible. However, even when this type of preferred share exists, the liquidation preference will usually include accrued and unpaid dividends, which, absent specific agreement, cannot be satisfied by the issuance of shares. Accordingly, in such a case the corporation will have to retain sufficient cash to pay these accrued dividends.

269. The retention of cash to satisfy these liabilities may prevent the transaction from meeting the "substantially all" requirement of a type C tax reorganization for federal income tax purposes. *See* note 224 *supra*. Additionally, such payments will deplete the cash assets that would otherwise be transferred to the acquiring corporation, in some cases without a corresponding adjustment in the number of shares or units of securities that will be issued in the reorganization.

270. Gen'l Corp. Law, *supra* note 1, § 2007; CAL. CORP. CODE ANN. §§ 5004-08 (West 1955).

271. Gen'l Corp. Law, *supra* note 1, § 2007(a). The required shareholder vote is "approval of the outstanding shares." The meaning of this phrase is discussed in text accompanying note 40 *supra*.

272. Gen'l Corp. Law, *supra* note 1, § 2007(a).

273. *Id.* § 2007(b).

274. *Id.* § 2007(c).

275. *Id.*

If a demand for cash is filed, the board, in its discretion, may abandon an adopted plan without shareholder approval, in which case the election will not be effective and the shareholders will then be entitled to receive the assets in accordance with their rights and preferences upon liquidation.[276] It should be noted that a preferred shareholder is apparently not entitled to a choice between payment of his preference upon liquidation and dissenters' rights because these latter rights are withheld from shares that specify an amount payable in the event of a reorganization.[277]

For apparent reasons, if a corporation has outstanding preferred shares, the vote on any required plan of distribution should be taken at the time of the vote on the reorganization and election to wind up and dissolve. Additionally, these matters should form a single proposal for shareholder action since approval of less than all of these items could produce chaotic results. The required notice of adoption of the plan of distribution should probably be sent along with the required notice of approval of the reorganization[278] since the mailing of each notice marks the beginning of a thirty day period within which shareholders may elect to be paid cash for their shares.[279] If these demands exceed the amount permitted by the acquisition agreement, the reorganization and plan of distribution can be abandoned.[280]

The complications attendant to dealing with preferred shares in a winding up and dissolution proceeding following a sale-of-assets reorganization often dictate the use of a merger reorganization to effect the acquisition of a corporation with outstanding preferred shares. The agreement of merger will specify the consideration to be issued in exchange for the preferred shares.[281] If the merger reorganization is

276. *Id.* § 2007(d).

277. *Id.* § 1311. This section provides that the dissenters' rights provisions are not applicable to shares whose terms and provisions specifically set forth the amount to be paid in respect of such shares in the event of a reorganization or merger. The reference to "reorganization" will have to be read to include the consequent dissolution in a sale-of-assets reorganization in order for this provision to preclude a preferred shareholder from having both dissenters' rights under Chapter 13, *id.* §§ 1301-12, as well as his rights as a dissenter from a plan of distribution under section 2007(c). It would be pointless to accord both protective features to a preferred shareholder.

278. *Id.* § 1301(a).

279. *Id.* §§ 2007(c), 1301(b). The thirty day period obviously has no application to dissenters' rights for marketable securities. *See id.* § 1301(b).

280. For a discussion of the possible problem incident to revoking a voluntary election if the reorganization is not consummated, see notes 252-53 *supra* and accompanying text.

281. Many preferred share contracts specify that a merger or consolidation will not

approved by the requisite vote of each class or series, the holders of these preferred shares will be required to accept this consideration unless they exercise any dissenters' rights to which they are entitled. If the preferred shares are subject to the marketable securities exception from dissenters' rights, no cash will have to be paid out for these shares.[282] Additionally, even if this exception is not available, if the preferred shares are themselves marketable securities,[283] the special requirements for perfecting dissenters' rights for these shares may tend to minimize the demands and consequently the cash that will have to be paid for these shares.[284]

After the corporation has completed the distribution of its assets to shareholders and has otherwise been completely wound up, a certificate of dissolution must be filed with the Secretary of State.[285] A precondition to the filing of such a certificate is the filing of a certificate issued by the Franchise Tax Board to the effect that all taxes imposed by the Bank and Corporation Tax Law have been paid or secured.[286] An undertaking from the acquiring corporation to pay these taxes is usually sufficient to obtain this certificate. Upon the filing of the certificate of dissolution the existence of the corporation ceases except for the purpose of further winding up if needed.[287]

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trigger the liquidation preference requirements. Additionally, a number of courts in other states have construed liquidation preference provisions as being inapplicable to merger or consolidation proceedings even in the absence of a specific provision to this effect. Some of these cases are cited in Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243, 261 (1954).

282. Gen'l Corp. Law, *supra* note 1, § 1300(b)(1).

283. The term "marketable securities" is a defined term in this article. *See* note 198 *supra*.

284. *See* Gen'l Corp. Law, *supra* note 1, § 1300(b)(2) which requires that marketable securities must be voted against the reorganization in order to perfect dissenters' rights for these shares; *id.* § 1301(b) which requires that the demand to perfect dissenters' rights for marketable securities be received no later than the date of the shareholders' meeting to vote on the reorganization.

285. *Id.* § 1905(a). This section also specifies the requirements for the certificate of dissolution which must be signed by a majority of the directors then in office. As an alternative to filing the certificate of dissolution the board may petition for a judicial declaration that the corporation is duly wound up and dissolved. *Id.* § 1907.

286. *Id.* § 1905(b).

287. *Id.* The GCL provides that a corporation that is dissolved nevertheless continues for the purpose of winding up its affairs, prosecuting or defending actions by or against it, enabling it to collect and discharge obligations, dispose of and convey its property, and collect and divide its assets. Further, no action or proceeding to which the corporation is a party abates as a result of the dissolution or proceedings for winding up and dissolution. Assets omitted from the winding up continue in the dissolved corporation for the benefit of the persons entitled to these assets, and upon their realization they must be distributed accordingly. *Id.* §§ 2010(a)-(c).

4. Application of the "Pseudo-Foreign" Corporation Provisions to Business Combinations

With few exceptions, prior law does not impose requirements upon corporations organized under the laws of other jurisdictions, irrespective of the nature and extent of a company's contacts with California.[288] The drafters of the GCL believed that it would be pointless to establish new requirements for the protection of shareholders and creditors if these could be avoided merely by incorporating or reincorporating in another state. The GCL thus provides that a foreign corporation with specified minimum contacts with California (a so-called "pseudo-foreign" corporation) will be subject to certain of the provisions of California law that are designed to protect California shareholders and creditors.[289]

In order for these provisions to apply to a foreign corporation, more than one-half of its business must be conducted in California and more than one-half of its outstanding voting securities must be held of record by persons having addresses in California.[290] If a foreign corporation meets both of these tests, certain of the provisions of the GCL, including those dealing with the authorization and approval of reorganizations and dissenters' rights, will apply to that corporation to the exclusion of the laws of the state where it is incorporated.[291]

The complete consequences of this new requirement on business combinations involving pseudo-foreign corporations will probably not be known for a considerable period of time, at least until the business combination provisions of all other state laws have been examined in the context of the GCL's requirements. Nevertheless, the following observations can be made. The pseudo-foreign corporation provision will, in many instances, impose more stringent requirements for investor and creditor protection on foreign corporations than the laws of the state of

288. *See, e.g.*, CAL. CORP. CODE ANN. § 830 (West 1955) (relating to indemnification of directors and officers).

289. Gen'l Corp. Law, *supra* note 1, § 2115.

290. *Id.* § 2115(a). More than one-half of a corporation's business is done in California when the average of the property factor, payroll factor, and sales factor (as defined in CAL. REV. & TAX CODE ANN. §§ 25129, 25132, 25134 (West 1970)) of that company exceeds fifty percent during its latest full tax year. Gen'l Corp. Law, *supra* note 1, § 2115(a). This section also applies to a foreign parent corporation that does not itself transact intrastate business in California if the parent meets the test for business done in California through the activities of one or more subsidiary corporations. *Id.* Voting securities held in the name of broker-dealers or their nominees are not treated as outstanding for the purpose of the shareholding test. *Id.*

291. Gen'l Corp. Law, *supra* note 1, § 2115(b). Chapters 12 and 13 of the GCL, as well as the equal treatment and common share exchange requirements of section 1101, will apply to a psuedo-foreign corporation with the required California contacts. *Id.*

their incorporation. Additionally, it is unlikely that this provision will create a conflict between California law and foreign law in the sense that in a business combination one state will require a corporation to take action that is prohibited by the other. However, there will undoubtedly be instances in which action permitted by one law will be prohibited by another. For example, section 1201(f) permits shareholder approval of a reorganization either to precede or follow action by the board, but the law of another state may require that shareholder action be taken only after board action.

This provision will create considerable difficulties to the extent that it is viewed by courts in California, but not by those in foreign states, as preempting foreign law rather than as an additional law that must be observed.[292] These problems will naturally arise where the foreign law contains different requirements than the GCL, such as where it provides for different procedures or rights. In this connection consider the Delaware and California dissenters' rights statutes. Delaware requires that judicial proceedings to resolve dissenters' rights issues be adjudicated in Delaware courts,[293] whereas the California courts are considered to be the appropriate forum for resolving disputes under Chapter 13 of the GCL.[294] In addition, a dissenter under Delaware law is entitled to the "value" of his dissenting shares on the effective date of the merger[295] whereas the GCL gives a dissenting shareholder the "fair market value" of his dissenting shares on the day preceding the first announcement of the terms of the proposed transaction.[296] It is apparent that these different procedures and standards can produce vastly different results, but it is far from clear that a court will conclude that following the GCL procedures and standards will obviate the necessity for also observing the Delaware requirements.

The pseudo-foreign corporation provision has no application to any corporation with outstanding securities listed on any national securities exchange certified by the Commissioner of Corporations for purposes of the exemption from qualification under the California Corporate Securities Law of 1968.[297] These corporations are excluded from this provi-

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292. The plain meaning of the language of section 2115(b) is that of preemption. *See* text accompanying note 291 *supra*.

293. DEL. CODE ANN. tit. 8, § 262(c) (1974).

294. Gen'l Corp. Law, *supra* note 1, § 1304(a).

295. DEL. CODE ANN. tit. 8, § 262(b) (1974).

296. Gen'l Corp. Law, *supra* note 1, § 1300(a); see text accompanying notes 193-98 *supra*.

297. Gen'l Corp. Law, *supra* note 1, § 2115(e).

sion basically on the theory that the geographical shareholder distribution requirements of these exchanges will in all likelihood preclude these corporations from meeting the California share ownership test.

5. Transition from the Prior Law to the GCL

The GCL does not become effective until January 1, 1977.[298] The forthcoming effectiveness of the GCL naturally raises the issue of whether the prior law or the GCL or perhaps both will govern a particular business combination. The GCL contains three transition rules of general application and three rules that bear directly on business combinations. The specific rules control to the extent that they produce a different result than the general rules.[299] The first general rule is that the GCL applies on and after January 1, 1977 (the "effective date" of the GCL) to all corporations existing on that date and to all actions taken by the directors or shareholders of these corporations on and after that date.[300] The second rule is that all the provisions of the GCL governing acts, contracts, and other transactions by a corporation or its directors or shareholders apply only to those acts, contracts, and transactions occurring on or after the effective date, and the prior law governs those that occurred prior to that date.[301] The final general rule is that any vote or consent by the directors or shareholders of a corporation prior to the effective date that is in accordance with the prior law will be effective in accordance with that law, and if any certificate or document is required to be filed in any public office relating to that action, it may be filed after January 1, 1977 in accordance with the prior law.[302]

There are separate specific transition rules for business combinations, shareholders' meetings and consents and voluntary winding up and dissolution proceedings. The merger, reorganization, and dissenters' rights provisions in Chapters 11, 12 and 13 of the GCL will, with one exception, apply to transactions consummated after the effective date.[303] The one exception is that prior law will apply to a transaction if a required shareholder approval is given prior to that date.[304] This exception is itself subject to a further exception. Prior law will apply to a business combination even if a required shareholder approval of that transaction is given after the effective date, provided that the approval is

298. *Id.* § 2300.
299. *Id.* § 2301.
300. *Id.* § 2301(a).
301. *Id.* § 2301(b).
302. *Id.* § 2301(c).
303. *Id.* § 2313.
304. *Id.*

given at a meeting initially called for a date before January 1, 1977.[305] The obvious purpose of this exception is to avoid the inadvertent application of the GCL that would result from an unforseen postponement beyond the effective date of a shareholders' meeting called for a date prior to the effective date. Absent this exception, a postponed meeting, which might be occasioned by lack of a quorum or litigation, might necessitate the restructuring of the transaction to assure compliance with the GCL.

The special transition rule for the shareholders' meeting and consent provisions of the GCL, Chapters 6 and 7, provides that the GCL will apply to any meeting held after the effective date and to any written consent that becomes effective after that date, as well as to any vote cast at such a meeting or consent given for such an action.[306] This principle governs even though a shareholder may have executed a proxy or written consent prior to the effective date with respect to such a meeting or action. Nevertheless, the prior law will apply to a meeting held after the effective date and to any vote cast if the meeting was initially called for a date prior to the effective date and notice of that meeting was given to the shareholders entitled to vote at the meeting.[307]

The final special transition rule applicable to business combinations deals with voluntary winding up and dissolution proceedings. The GCL sections dealing with these proceedings apply to any proceeding initiated by the filing of a certificate of election after January 1, 1977.[308] Prior law governs any proceeding initiated by a filing before the effective date.[309]

It is apparent that the different transition rules for reorganizations and dissolution proceedings could result in the former being governed by the prior law and the latter by the GCL. This will occur if shareholder approval of a sale-of-assets and voluntary dissolution is given just prior to the effective date, but the certificate of election is filed after that date.

6. Accounting Considerations

Under existing generally accepted accounting principles a business combination will be accounted for as a "pooling of interests" or as a

305. *Id.* Query whether increasing the length of time from the date a meeting is called for until the date it is actually held will affect the application of this exception.
306. *Id.* § 2310.
307. *Id.*
308. *Id.* § 2315.
309. *Id.*

"purchase," depending on the nature of the transaction and the surrounding circumstances.[310] The pooling of interests method accounts for a combination as if no acquisition had occurred, *i.e.*, as the uniting of the ownership interests of two or more companies through an exchange of equity securities.[311] The recorded assets and liabilities of the combining corporations are carried forward to the combined enterprise at their recorded amounts.[312] The stockholders' equities of the combining companies are combined,[313] and the recorded income of the combining parties for the current and all prior periods is combined and restated as income of the continuing corporation.[314]

By contrast, the purchase method accounts for a combination as acquisition of one company by another.[315] The acquiring corporation records at its cost the acquired assets less liabilities assumed.[316] The difference between the cost of an acquired company and the aggregate fair value of the identifiable acquired assets less the liabilities assumed is recorded as goodwill.[317] The reported income of an acquiring corporation includes the operations of the acquired corporation only after acquisition.[318] There is no restatement of the income of the acquiring corporation to include the historical operating results of the acquired corporation. Additionally, the goodwill arising from the excess of cost over acquired net assets will be amortized against the future income of the continuing corporation.[319]

The accounting treatment given a business combination under generally accepted accounting principles will control the accounting and financial attributes of the acquiring corporation for purposes of the GCL.[320] These attributes include the various balance sheet and operat-

310. Accounting Principles Board Opinion 16, ¶ 8, 2 CCH ACCT. PRIN. 6639-40 (1968) [hereinafter cited as APB 16]. APB 16 specifies both the requirements for the applicability of each of these methods of accounting for business combinations as well as the consequent accounting treatment required by each method. These requirements are discussed in Scriggins, *Business Combinations—Developments in Combining Techniques and Constraints in Accounting Rules*, 27 BUS. LAWYER 1245, 1250-55 (1972).

311. APB 16, *supra* note 310, ¶ 12, at 6640.

312. *Id.* ¶¶ 51-52, at 6649-50.

313. *Id.* ¶ 53, at 6650.

314. *Id.* ¶ 56, at 6650-51.

315. *Id.* ¶ 11, at 6640.

316. *Id.* ¶¶ 66-89, at 6652-56.

317. *Id.* ¶ 91, at 6655.

318. *Id.* ¶ 11, at 6640.

319. Accounting Principles Board Opinion 17, ¶¶ 27-31, 2 CCH ACCT. PRIN. 6665-66 (1968).

320. *See* Gen'l Corp. Law, *supra* note 1, §§ 114, 1500-01. Section 114 provides that all references in the GCL to financial statements and accounting items mean financial

ing statement accounts which are pertinent in ascertaining whether a corporation is permitted by Chapter 5 of the GCL to pay dividends or make other distributions to its shareholders.[321] Accordingly, for example, a reorganization which must be accounted for as a pooling of interests will, among other things, increase the retained earnings account of the acquiring corporation by the amount of the retained earnings of the acquired company, thus increasing the legal source available for shareholder distributions. Conversely, any deficit in the retained earnings account of the acquired corporation will reduce the balance in the same account of the acquiring corporation.

The pooling of interests method of accounting has been a favored and sought after treatment. This method of accounting avoids the creation of goodwill and its consequent amortization, and it permits an acquiring corporation to include in its operating results for the fiscal period in which the acquisition is made the operating results of the acquired corporation for the same period. Additionally, pooling rather than purchase accounting avoids recording the acquired assets at the acquiring corporation's cost which would require higher consequent charges for amortization and depreciation to future income than if the historical cost to the acquired corporation were employed.

For these and other reasons many business combinations are structured to satisfy the conditions for pooling of interests accounting.[322] The GCL's extension of dissenters' rights to all forms of business combinations involving the issuance of equity securities may create a problem in satisfying one of the conditions to the pooling of interests treatment. This condition requires that the acquiring corporation issue only voting common stock in exchange for substantially all of the voting common

statements and accounting items prepared or determined in accordance with generally accepted accounting principles and fairly presenting the matters which they purport to present, unless a specific accounting treatment is required by a particular provision. This section also provides that references to financial statements of corporations with subsidiaries will generally mean consolidated financial statements for the corporation and such of its subsidiaries as are required or permitted to be included in such consolidated statements under generally accepted accounting principles, and references to accounting items for such corporations mean such items determined on a consolidated basis in accordance with such consolidated financial statements. *Compare id.* § 114 *with* CAL. CORP. CODE ANN. §§ 3905, 4117 (West Supp. 1975) which permitted an acquiring corporation in a sale-of-assets or merger to increase its earned or paid-in surplus by the amounts appearing on the books of the acquired corporation to the extent that this was permitted by generally accepted accounting principles. In this connection, it should be noted that the GCL generally eliminates all concepts of par value, capital, paid-in surplus, and reduction surplus.

321. *See* Gen'l Corp. Law, *supra* note 1, §§ 500, 502-03.

322. These requirements appear in APB 16, ¶¶ 45-59, *supra* note 310, at 6645-49.

stock interest of the acquired corporation.[323] The "substantially all" test will be met if at least ninety percent of the acquired corporation's voting common stock interest is acquired for voting common stock of the acquiring corporation.[324] The exercise of dissenters' rights by shareholders of the acquired corporation naturally reduces the interests acquired for voting common stock and can therefore prevent the combination from meeting the ninety percent test. Additionally, the extent of the exercise of dissenters' rights by shareholders of the acquiring corporation may also prevent pooling of interests treatment.[325]

IV. CONCLUSION

The objective of the project that produced the GCL was to modernize and streamline California corporate law in order to facilitate the conduct of modern corporate business while maintaining and expanding the protection of shareholder and creditor rights.[326] By any reasonable standard, the GCL has achieved this objective in the area of business combinations.

The conceptual approach of the GCL to business combinations has been to establish and apply shareholder safeguards on the basis of need rather than on the basis of the form of the transaction. The logic of this approach is self-evident, and the implementation of this concept has been both thoughtful and consistent. Consistency in application has yielded when required by the dictates of reason, thus heeding Emerson's famous admonition about foolish consistency.[327] For example, the section 1201(b) voting power dilution exception to shareholder approval could not rationally be applied to preclude shareholder action when fundamental changes in shareholder rights might occur, and for this reason the exceptions to this exception appearing in sections 1201(c), (d) and (e) are appropriate.

The GCL has identified and resolved in a responsible way significant conflicts between corporate necessity and shareholder protection. The equal treatment and common share exchange requirements of section 1101 are two examples of what appears to be a good balance between the competing needs of modern corporate enterprises and the needs of

323. *Id.* ¶ 47b, at 6646.

324. *Id.*

325. *See id.* ¶ 47c, at 6648.

326. ASSEMBLY REPORT, *supra* note 43, at 1.

327. "A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines." Ralph Waldo Emerson, *Self Reliance* (1841), in AMERICAN POETRY AND PROSE 441 (5th ed. 1970).

shareholders and creditors. This balance and the means by which it has been achieved may well have placed California in the forefront of modern state corporation laws for many years to come.

Nevertheless, it appears that the GCL may not be the final word in the regulation of California corporations and their activities. *Green v. Santa Fe Industries, Inc.*[328] and *Marshel v. AFW Fabric Corp.*[329] may be precursors of a major body of judicially formulated, federal corporate law. It would be naive to advocate that federal law should not affect the activities of state chartered corporations. There are many areas where Congress has mandated that the national interest justifies federal action, and in the regulation of the issuance of securities and securities markets federal law is an accepted fact of corporate life. Regardless of the extent to which one may agree or disagree with the results in *Green* and *Marshel*, the logic of those decisions raises a very fundamental question: Will federal courts preempt state regulation of corporate affairs that touch upon securities matters, through a process of finding "inherent fraud" and a consequent violation of rule 10b-5?

This type of federal intervention would be extremely unfortunate. It would subject corporate action to a significant degree of uncertainty because the validity of a transaction would depend upon the varying concepts of fairness held by various members of the federal judiciary. This is not meant as a criticism of the judgment of federal courts but rather as an observation that a substantial degree of subjectivity would be injected into any decision on the validity of a corporate transaction which touches on a securities matter. Even more troublesome than this uncertainty is the stifling effect that federal judicial action of this type may have on the development of state legislative and judicial solutions to complex legal corporate problems. State law must be permitted to function if it is to evolve. In the long run, federal judicial intervention such as *Green* and *Marshel* may prove to be counterproductive because it will inhibit responsive state action, which is the key to effective regulation of corporations and their controlling persons.

328. See notes 167-81 *supra* and accompanying text.
329. See notes 117-22 *supra* and accompanying text.