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Important Legal Effects Of California Short-Form Mergers

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Law360, New York (September 09, 2014, 12:40 PM ET) -- Mergers can offer participating corporations a number of potential benefits. Shareholders may disagree, however, with whether a merger is beneficial to their or the corporation's interests. A minority shareholder might seek to block a merger or seek excessive compensation in exchange for his or her consent by threatening litigation to complicate or prevent the merger.

The California Corporations Code provides a streamlined merger procedure — called a "short-form merger" — which significantly limits the rights of dissenting shareholders. As a recent California state appeals court decision holds, a corporation that offers a dissenting shareholder payment for the "fair market value" of his or her shares in the context of a short-form merger involving "common control" of the merging entities may cut off the dissenting shareholder's ability to utilize the threat of claims for damages to prevent the merger or obtain unwarranted compensation for his or her shares to permit the merger to proceed. Corporate practitioners and litigators — as well as anyone involved in a potential short-form merger — should be aware of this recent authority and its implications.

The Short-Form Merger Process

Effecting a short-form merger is a relatively straightforward process. Put simply, shareholders holding 90 percent or more of the shares — called the "control group" — of a corporation — called the "target" — contribute their shares to a newly formed corporation — called the "parent" — in exchange for all of the parent's shares. The control group thereafter owns 100 percent of the parent's stock, and the parent holds at least 90 percent of the shares of the target.

The target is then merged into the parent — or vice versa — pursuant to Section 1110 of the California Corporations Code, upon the approval of the target's and parent's respective boards of directors.

Cashing Out Dissenting Shareholders

What happens to shareholders of the target who disagree with the merger and refuse to tender their shares to the parent? The control group, as part of the merger, may offer to "cash out" those "dissenting shareholders" by paying them the "fair market value" of their shares.

The dissenting shareholders are then put to a choice under Sections 1301 and 1312 of the California Corporations Code: Within 30 days of the target's mailing of notice of the directors' approval of the merger, the dissenting shareholders must elect to (1) accept the target's offered price and tender their shares to the target for payment and cancelation of the shares, (2) tender their shares to the target for payment of a different claimed price and cancellation of the shares, or (3) reject the merger and bring an action with the Superior Court "to test whether the number of shares required to authorize or approve the reorganization have been legally voted in favor" of the reorganization.

Under Sections 1304 and 1305 of the California Corporations Code, should a dissenting shareholder elect the second option, and should the shareholder and the target fail to reach an agreement on the price to be paid for the shares, either party may bring an action in the Superior Court for an appraisal of the shares by the court or a court-appointed appraiser. The appraised amount is then reduced to a judgment and paid to the shareholder, and the shares are canceled.

Should the dissenting shareholder elect to reject the merger and bring an action with the Superior Court, the "action" it may bring is quite limited. Such an action may only test whether the necessary number of votes approved the merger. California Corporations Code Section 1312, subdivision (a) (Section 1312(a)) provides that the dissenting shareholder has no right "at law or in equity to attack the validity of the reorganization or short-form merger, or to have the reorganization or short-form merger set aside or rescinded[.]" California's Supreme Court and Courts of Appeal have consistently held that Section 1312(a) prohibits claims by dissenting shareholders for damages, including for fraud, misrepresentation, or otherwise.

In Steinberg v. Amplica Inc (1986) 42 Cal.3d 1198, the California Supreme Court held pursuant to Section 1312(a) that a shareholder claiming that his or her shares were undervalued as a result of fraud and breach of fiduciary duty may not bring an action for compensatory and exemplary damages, but must instead proceed with a claim for appraisal of his or her shares.

Limitation Upon Claims By Dissenting Shareholders In Mergers Involving Common Control

There is a notable exception to this limitation of claims. Pursuant to subdivision (b) of Corporations Code Section 1312 (Section 1312(b)), where either of the target or parent is controlled by the other, or both the target and the parent are under common control, the dissenting shareholder has another option, namely, to reject the merger entirely and pursue whatever claims the dissenting shareholder might have "to attack the validity of the reorganization or short-form merger or to have the reorganization or short-form merger set aside or rescinded."

Of course, short-form mergers will often involve a situation of common control between the target and parent; that is the nature of the target-parent relationship. So, the question arose whether Section 1312(b) permits a dissenting shareholder to bring the sort of damages claims that Section 1312(a)

otherwise precludes. A recent state appeals court decision answers that question with “no.”

Following Steinberg v. Amplica Inc., the appeals court in Busse v. United PanAm Financial Corp. (2014) 222 Cal.App.4th 1028, held that in a case of common control under Section 1312(b), the exception to Section 1312(a) does not allow a dissenting minority shareholder to bring common law claims for monetary damages for breach of fiduciary duty, although the dissenting minority shareholder may seek to have the merger rescinded.

Busse involved PanAm Financial, which makes subprime loans on used cars. PanAm went public in the late 1990s, but saw its share price decrease significantly over the course of the recession. Guillermo Bron — who founded PanAm and held 38 percent of its stock and, allegedly, control of its board of directors — sought to take PanAm private. An independent committee at PanAm valued the stock for purposes of a buyout. The committee and the board of PanAm then recommended that PanAm’s shareholders approve the buyout by Bron and certain of his partners at the stated stock value, and the next day, the buyout was announced.

Three shareholders filed class action lawsuits, alleging breach of fiduciary duty. The shareholders sought an injunction to prevent the buyout, or, in the alternative, to rescind the buyout transaction and obtain awards of “rescissionary” and compensatory damages

The outstanding shares of PanAm approved the buyout in a relatively close vote. Thereafter, the shareholders filed amended complaints, seeking rescission of the buyout and “rescissionary damages” for breach of fiduciary duty and “aiding and abetting breach of fiduciary duty” pursuant to Section 1312(b). The trial court sustained demurrers by Bron and others on the grounds that Section 1312(b) does not permit claims for damages, even if claimed to be an “equitable remedy” related to rescission, and that the complaints failed to adequately allege “common control” of the merging entities.

The Court of Appeal, reviewing the history of Civil Code Section 1312, held that in enacting subdivision (b) of Section 1312, the Legislature presumably was aware of California cases holding that a dissenting shareholder’s exclusive remedy was an appraisal. Nevertheless, the Legislature gave no indication of an intent to grant dissenting shareholders a right to monetary damages that prior case law otherwise prohibited. The Court of Appeal held that it could “find no evidence the Legislature wanted, in subdivision (b) [to Section 1312] to establish or even recognize a monetary remedy that hadn't previously been there[.]” Rather, the Court of Appeal held, the Legislature “merely wanted to add one additional big, but wholly equitable, stick to the remedies minority stockholders already had — the ability to sue to set aside a reorganization.”

Addressing Steinberg and a host of other decisions and legislative history, the Court of Appeal held that pursuant to Section 1312(a), “[d]isappointed minority shareholders cannot sue to stop or rescind a merger, and are limited to the remedy of appraisal,” which the Court of Appeal held, “is an adequate remedy because the appraisal can take into account breaches of fiduciary duty by corporate insiders.” Moreover, the Court of Appeal held, there was “no indication the Legislature, in enacting subdivision (b) [of Section 1312], wanted to give subdivision (b) plaintiffs a right to monetary damages[.]” The Court of Appeal held that allowing claims for monetary damages pursuant to Section 1312(b) “would also tend to subvert the appraisal remedy itself and allow the kind of gamesmanship the statutes indicate the Legislature sought to avoid” by way of the short-form merger statutes.

The Court of Appeal also noted California Corporations Code Section 1308, which precludes a shareholder who tenders his or her shares for payment from withdrawing that demand without the

corporation’s consent. The Court of Appeal held that Section 1308 “was obviously included to prevent dissenting shareholders from giving themselves a free stock option in the event that after the reorganization share prices declined.”

The Court of Appeal held that allowing claims for monetary damages pursuant to Section 1312(b) “would allow dissenting stockholders to hedge their bets by disclaiming an appraisal remedy on the theory the company's offer was submarket as a result of breach of fiduciary duty, and if the gamble didn't pay off because share prices unexpectedly went down, they could simply dismiss their case,” effectively granting dissenting shareholders the “free stock option” Section 1308 was intended to avoid.

The Court of Appeal affirmed the trial court’s order sustaining the demurrer to the extent it prohibited the plaintiffs from seeking damages awards, but reversed the order insofar as it precluded the plaintiffs from seeking to unwind the buyout.

At bottom, a dissenting shareholder in a short-form merger involving common control may bring an action to unwind a buyout, but may not seek an award of monetary damages pursuant to Section 1312(b) or for common law claims of fraud or breach of fiduciary duty. This is so even if the dissenting shareholder seeks to state its claim for damages as an equitable remedy. Both sides in a disputed short-form merger should bear in mind the extent of a dissenting shareholder’s remedies, to avoid potential overreach in structuring or challenging the merger.

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