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To Our Clients

Going Private

Section 1101 of the California General Corporations Law which became effective on January 1, 1977 completely prohibited cash freezeouts by a shareholder who owns more than 50% but less than 90% of the stock of a corporation without the unanimous consent of all shareholders. Recognizing that the unaniminity requirement subjected the majority of the minority to the tyranny of one shareholder, the California Legislature added Section 1101.1, effective January 1, 1978, providing an exception to the prohibition of cash freezeouts if the Commissioner of Corporations approves the fairness of the transaction. In the first decision interpreting Section 1101.1 the California Commissioner held that the exception applies only when the majority of the minority approves the cash freezeout and the Commissioner's determination of fairness is not appropriate and will not be made when the majority of the minority object to the freezeout. Matter of Johnson & Johnson, File No. 304 2639 (Calif. Dept of Corp., July 28, 1978).

This decision and the policy underyling the statutory provisions as amended support the policy argument that a cash freezeout should be permitted when full disclosure has been made, the freezeout has been approved by a majority of the minority and the terms of the transaction are fair and that all other considerations, such as business purpose, are not relevant. An interesting article on the issue of fair value in freezeouts is B.C. Toms, Compensating Shareholders Frozen Out In Two-Step Mergers, 78 Col. L. Rev. 548 (1978).

The following quotation from the opinion summarizes the holding:

> Except for Section 1101.1 of the General Corporation Law the cash-out merger proposed by Applicant would have been prohibited by the last two sentences of Section 1101 of said Law. The crucial question then is: "What did the legislature intend when it enacted Section 1101.1?" Or, "In what manner is the public policy of absolute prohibition set forth in Section 1101 affected by Section 1101.1?"

The enactment of the California General Corporations Law, effective January 1, 1977, evidences the philosophy and intent of the California Legislature to prohibit cash "freeze out" or "squeeze out" or "going private" transactions without the consent of all shareholders, where a shareholder owning more than 50 percent but less than 90 percent of outstanding common shares of a corporation, attempts to completely eliminate minority common shareholders. The purpose of this philosophy is to preclude majority owners (but less than 90 percent owners) of common shares of a corporation from preventing minority shareholders to continue as common share owners of the corporation, or any of its successros, unless all shareholders unanimously agree to the transaction. If the minority common shareholders do not unanimously agree to be paid cash for their common stock interests, they may vote against a merger, reverse stock split or sale of assets, and remain as equity owners. (§§ 407, 1001, 1101, California Corporations Code)

The California Legislature recognized that there may be situations when the will of the shareholders, majority as well as minority, could be frustrated by one intransigent shareholder. Accordingly, it amended the General Corporation Law by adding to it § 1101.1, effective January 1, 1978, to provide an exception to § 1101. The purpose of § 1101.1 is to provide a means whereby mergers eliminating minority shareholders could take place if certain administrative agencies, such as the Department of Corporations, approved the fairness of the terms and conditions of the transaction. (§ 1101.1, California Corporations Code)

The exception from the general intent and philosophy of the General Corporations Law is limited and narrow, and is to be applied only where a small limited number of minority shareholders object to a proposed transaction. On page 15 of the 1978 pocket part to Volume 17 of California

Corporation Law and Practice, Harold Marsh, Jr. referring to Section 1101.1 (and the comparable subdivision (e) of Section 1001) of the General Corporation Law states:

> "These provisions were adopted on the basis of argument that in some cases a proposed payment of cash to the minority shareholders might be desired by all or almost all of such shareholders and might in fact be highly generous to them and that a veto power over the transaction should not be given to one single minority shareholder no matter how small his interest in the corporation. Therefore, it was concluded that there should be provided an 'escape valve' whereby such transaction could be effectuated if it were approved by one of these public officials after a hearing upon notice to all of the shareholders affected."

There are 693,172 shares of Bactomatic Common Stock held by the minority shareholders. As at June 5, 1978, only 46,675 of said 693,172 shares were voted in favor of the merger whereas 494,090 of said 693,172 shares were voted in opposition to the merger. The vote was about 7% yes and about 72% no, with about 21% not voting either yes or no, hardly a situation wherein a single minority shareholder is thwarting the wishes of all the other minority shareholders. On the contrary what we have is a situation wherein but a small number of the minority shareholders are for being cashed out.

As before noted there is no assurance that Bactomatic can obtain any further funding in which case bankruptcy is a distinct possibility. However, the minority shareholders are aware of this possibility. Applicant has gone to great lenghts to so inform them. Nonetheless, they have voted overwhelmingly to accept that risk. Under these circumstances for the Department to

disregard the collective judgment of the minority shareholders is outside the intent of Section 1101.1. It is not the purpose of Section 1101.1 to substitute the Department's judgment for that of the minority shareholders. Section 1101.1 does not appoint the Department as the caretaker for the minority shareholders. It does not instruct the Department to decide what is best for the minority shareholders. It does not presume that the minority shareholders cannot look out for their own interests. For the Department to so conclude would be tantamount to the Department's repealing the last two sentences of Section 1011 and inserting itself in lieu thereof which clearly is not the purpose of Section 1101.1. There is no reason to assume that the legislature intended the Department to proceed as if the last two sentences of Section 1101 were not present.

To allow Applicant to utilize the provisions of Section 1101.1 to cash out the minority shareholders of Bactomatic is to permit its use in a manner inconsistent with what the legislature intended when it enacted the section. Instead of being an 'escape valve' to prevent a single or a few shareholders from denying a cash out wanted by the vast majority of the minority shareholders, and which is otherwise fair, which is what the legislature intended, Applicant (the majority shareholder of Bactomatic), a small number of the Bactomatic minority shareholders, and the Department will combine to force an unwanted cash out on the vast majority of the minority shareholders, exactly the opposite of what the legislature intended when it enacted Section 1101.1.

The wishes of the minority shareholders is paramount. The Bactomatic minority shareholders considered as a class do not want to be cashed out. The Department will respect that determination. To act otherwise would expand the meaning of Section 1101.1 beyond the intention of the legislature and thereby pervert its purpose.

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