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Acquisitions: A unique defense for publicly traded companies under attack

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Shareholders of publicly traded companies almost always bring suit after announcement of an acquisition. Shareholders typically claim that the target's directors violated their fiduciary duties by failing to maximize shareholder value and to disclose sufficient information to shareholders. When faced with motions to preliminarily enjoin proposed acquisitions, defendants often settle rather than risk delaying consummation of the acquisition.

When the target company is incorporated in California, however, defendants have a unique defense that is not available when the company is incorporated elsewhere. Corporations Code Section 1312(a) makes statutory appraisal the exclusive remedy for shareholders challenging corporate acquisitions, and precludes motions to enjoin mergers. As explained in *Steinberg v. Amplica Inc.*, 42 Cal. 3d 1198 (1986), the state Legislature enacted Section 1312(a) precisely to protect against strike suits.

Section 1312(a) provides that "[n]o shareholder of a corporation who has a right under this chapter to demand payment of cash for the shares held by the shareholder shall have any right at law or in equity to attack the validity of the reorganization or... set aside or rescind [it]." Under the case law, Section 1312(a) prohibits both an action to enjoin a merger and an action for damages after the merger has taken place.

Section 1312(a) applies to all shareholders who have "a right under [Chapter 13 of the Corporations Code] to demand payment of cash" for their shares. In the merger context, shareholders of target corporations indisputably have the right to demand payment of cash for their shares. Specifically, Chapter 13 allows dissatisfied shareholders to demand fair market value for their shares, and if an agreement cannot be reached, seek relief through a statutory appraisal action. Indeed, proxy statements typically advise shareholders of this right. Plaintiffs have made two arguments to avoid the applicability of Section 1312(a), but neither has merit.

There is a distinction in the Corporations Code between a shareholder having the right to demand payment of cash for shares under Chapter 13, which is all that is required for Section 1312(a) to apply, and a shareholder's actual entitlement to appraisal, which requires that the shareholder hold "dissenting shares" as defined under Section 1300(b). For example, when a target company's shares trade on a national securities exchange, a shareholder holds "dissenting shares" only when, among other things, 5 percent or more of the class of shares held by the shareholder have demanded payment under Chapter 13.

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Plaintiffs have argued that Section 1312(a) is applicable only if the shareholder's shares constitute "dissenting shares." In the case of publicly traded companies, demands for payment under Chapter 13 are not filed until after shareholder approval of the merger. Because it will never be known until after the shareholder vote is completed whether the 5 percent threshold has been satisfied, plaintiffs have taken the position that Section 1312(a)'s bar to injunctive relief does not apply when the target corporation's shares trade on a national securities exchange. This argument is baseless.

First, Section 1312(a) applies to all shareholders who have a "right...to demand payment" under Chapter 13, and makes no reference to "dissenting shares." In fact, Chapter 13 makes a clear distinction between "dissenting shares" and demands for payment. For example, for a shareholder of a corporation trading on a national securities exchange, it is a prerequisite to becoming a holder of "dissenting shares" that "demands for payment" are filed by 5 percent or more of the class of shares held by that shareholder. The Legislature clearly understood the difference between "dissenting shares" and "demands for payment," and chose not to limit the prohibition on injunctive relief in Section 1312(a) to holders of "dissenting shares."

Second, if shares had to qualify as "dissenting shares" before Section 1312(a) applied, the law would never bar attempts to enjoin a merger, even for non-public corporations. For example, one of the requirements under Section 1300(b) for holding "dissenting shares" is that, for public corporations, the shares "were not voted in favor of the reorganization," or, for non-public corporations, that the shares "were voted against the reorganization." This requirement can only be met after the shareholder vote. As such, the argument that a shareholder must hold "dissenting shares" before Section 1312(a) is applicable would violate state Supreme Court precedent holding that Section 1312(a) bars actions to enjoin mergers.

Section 1312(a), by its terms, contains an exception to the general rule that no shareholder shall have any right to challenge a merger. The exception to Section 1312(a) is "an action to test whether the number of shares required to authorize or approve the reorganization have been legally voted

in favor thereof." Plaintiffs have argued that pre-merger claims of inadequate disclosure fall within this exception. Because virtually every shareholder challenging an acquisition alleges inadequate disclosure, plaintiffs' construction of Section 1312(a) would allow plaintiffs to seek injunctive relief in nearly every lawsuit. Plaintiffs' interpretation is wrong.

First, on its face, Section 1312(a)'s exception applies only to challenges brought after the shareholder vote has occurred — not to challenges seeking to enjoin a transaction before the shareholder vote. There can be no action to test whether shares were "legally voted" before the shareholder vote has occurred.

Second, in *Sturgeon Petroleums Ltd. v. Merchants Petroleum Co.*, 147 Cal. App. 3d 134 (1983), the court rejected the argument that "failures of disclosure in soliciting" proxies fell within the Section 1312(a) exception even if the shareholder had been "defrauded" in the procurement of his vote. And in Singhania v. Uttarwar, 136 Cal. App. 4th 416 (2006), the court held that plaintiffs' allegations that directors had concealed information bearing on plaintiffs' decision whether to exercise dissenters' rights did "not remove plaintiffs from the ambit of [S]ection 1312(a)'s bar."

Finally, Henry Ballantine and Graham Sterling, the drafters of Section 1312(a)'s predecessor, state in a 1939 law review article that "[i]n using the phrase "legally votes" the draftsmen did not intend any implication that a vote which might otherwise be valid legally would be subject to invalidation on equitable grounds as, for example, on the ground that the casting of the vote was procured or motivated by fraud.... A "legal vote" is simply a vote cast by a person who is legally entitled to cast it."

Section 1312(a) effectively bars all actions challenging acquisitions of corporations. When a suit is brought challenging the acquisition of a California corporation, defense counsel should aggressively use Section 1312(a) as a defense.

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