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Special Considerations in California M&A Deals

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In addition to the deal-structuring issues that typically arise in any acquisition, M&A transactions involving a party incorporated or based in California raise a number of special issues and opportunities. Some of these issues affect permissible deal terms, deal structure and the manner in which a deal is consummated, and others apply generally to California employees.

Deal Lockups

Since the Delaware Supreme Court's decision in *Omnicare* in 2003 limited the ability of an acquirer to guarantee deal approval by means of voting agreements, private company acquisitions have routinely employed simultaneous "sign-and-close" and "sign-and-vote" transaction structures. In the former, the closing occurs concurrently with the initial signing of the acquisition agreement. In the latter, shareholders provide their approval by written consent immediately after the definitive acquisition agreement is signed.

Although California courts have not considered deal lockups and it is unclear whether California would follow *Omnicare* at all, California law does provide more flexibility than Delaware law in the protocol for obtaining merger approval from shareholders.

California law does not require a signed merger agreement to be adopted by shareholders, but only requires shareholder approval of the "principal terms" of the merger. Shareholder approval can occur before or after board approval of the merger and the signing of the merger agreement. Where the target is a California corporation, shareholder approval can proceed contemporaneously with the signing of the definitive agreement—and can even precede signing if the principal terms of the transaction do not change after shareholder approval.

By contrast, Delaware law requires the signed merger agreement to be adopted by stockholders. Since 2014, however, Delaware has permitted prospective execution of stockholder consents that can become effective upon the occurrence of a subsequent event, such as the board approval, execution and delivery of a final merger agreement. This mechanism can eliminate the delays between signing the merger agreement and obtaining stockholder approval—and the risk of a competing suitor emerging in the interim—that formerly existed under Delaware law.

Business Combinations

The California Corporations Code has a number of other provisions that may affect acquisitions and other business combination transactions:

– Section 1101 requires that, in a merger involving a California corporation, all shares of the same class or series of any constituent corporation be "treated equally with respect to any distribution of cash, rights, securities, or other property" unless all holders of the class or series consent otherwise.

  This requirement is potentially stricter than the comparable rules in Delaware, which have been interpreted—at least in some cases—to allow different forms of payment to be made to different holders of the same class of stock, as long as equivalent value is paid and minority shareholders are not disadvantaged.

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– Section 1101 also limits the ability of an acquirer in a "two-step" acquisition transaction (such as a tender offer followed by a second-step merger) to cash out untendered minority shares.

  If an acquirer holds between 50% and 90% of a California target's shares, the target's non-redeemable common shares and non-redeemable equity securities may be converted only into non-redeemable common shares of the surviving or acquiring corporation unless all holders of the class consent otherwise. This means that, in all-cash or part-cash two-step acquisitions of California corporations, the minimum tender condition needs to be 90%, which can be a difficult threshold to reach.

– With limited exceptions, Section 1201 requires that the principal terms of a merger be approved by the holders of a majority of each class of outstanding shares (unless a higher percentage is specified in the corporate charter). Therefore, the holders of any class of outstanding shares—including common stock, which generally is controlled by current and former founders and employees, rather than investors—can block or fail to approve a merger transaction even if such holders hold less than a majority of the total outstanding shares of the target.

  In contrast, Delaware law requires a merger to be approved by the affirmative vote of the holders of a majority of the outstanding stock entitled to vote on the matter; no class or series voting is mandated by statute.

– Section 1203 requires an "affirmative opinion in writing as to the fairness of the consideration to the shareholders" of the subject corporation in transactions with an "interested party." The statute is not confined to an opinion as to the fairness of the consideration "from a financial point of view"—the normal formulation in an investment banking fairness opinion—and it is unclear whether, and in what circumstances, a more extensive opinion may be required in a transaction subject to the statute.

  Section 1203 does not apply in acquisitions where the subject corporation has fewer than 100 shareholders, or in which the issuance of securities is qualified after a fairness hearing under California law, as discussed below.

"Quasi-California" Corporations

Section 2115 of the California Corporations Code—the "quasi-California" corporation statute—purports to impose various California corporate law requirements on corporations incorporated in other states, including Delaware, if specified tests are met. The law applies to any company other than a public company with shares listed on the Nasdaq Capital Market, Nasdaq Global Market, Nasdaq Global Select Market, NYSE or NYSE MKT, if that company:

– Conducts a majority of its business in California (as measured by property, payroll and sales tests); and

– Has a majority of its outstanding voting securities held of record by persons having California addresses.

If a corporation is subject to the quasi-California corporation statute, a number of California corporate law provisions apply—purportedly to the exclusion of the law of the corporation's jurisdiction of incorporation—including provisions that directly or indirectly affect M&A transactions. These California provisions, and their counterparts under Delaware law, address:

– Shareholder approval requirements in acquisitions (which are generally more extensive than the stockholder approval requirements under Delaware law);

– Dissenters' rights (which differ from Delaware law in a number of respects);

– Limitations on corporate distributions (which are more restrictive than under Delaware law);

– Indemnification of directors and officers (which is more limited than in Delaware);

– Mandatory cumulative voting in director elections (permitted but not required in Delaware); and

– The availability of the California fairness hearing procedure described below to approve the issuance of stock in an M&A transaction (an alternative to SEC registration that has no counterpart in Delaware law).

In 2005, the Delaware Supreme Court held that Section 2115 is invalid as applied to a Delaware corporation. Although existing California precedent upholds Section 2115, an appellate case in 2012 suggested that Section 2115 cannot compel California law to be applied when the matter falls within a corporation's internal affairs (for example, voting rights of shareholders, payment of dividends to shareholders, and the procedural requirements of shareholder derivative suits). However, no California appellate court has squarely ruled on the matter since the Delaware decision.

Unless and until Section 2115 is invalidated by the California Supreme Court, a non-California corporation acts at its peril in ignoring this statute, since its application to out-of-state corporations may depend on forum shopping and a race to the courthouse. Careful transaction planning is required if a non-California corporation is deemed to be a "quasi-California" corporation.

Fairness Hearings

In M&A transactions involving the issuance of stock, California law offers a relatively efficient and inexpensive alternative to SEC registration that still results in essentially freely tradable stock—a "fairness hearing" authorized by Section 3(a)(10) of the Securities Act of 1933.

The fairness hearing procedure is available where either party to the transaction is a California corporation, or a quasi-California corporation as discussed above. Fairness hearings are also possible if a significant number of the target's shareholders are California residents, regardless of the parties' jurisdictions of incorporation, or if the issuer is physically located in California or conducts a significant portion of its business in California.

There is no hard-and-fast rule as to how many target shareholders must reside in California before an acquisition can qualify for a California fairness hearing, but transactions have qualified when a significant minority of the target's shareholders have been California residents. There also is no definitive guidance on what constitutes conducting a significant portion of a company's business in California.

A fairness hearing is conducted before a hearing officer of the California Department of Business Oversight. The hearing officer reviews some of the disclosure documents, but there are few rules governing their content, and the documents—a notice to shareholders of the hearing, followed by an information statement—are much less extensive than a proxy statement or registration statement governed by SEC rules. At the conclusion of the hearing, and assuming that the hearing officer determines that the proposed transaction terms are fair, a permit is issued that "qualifies" the acquirer's securities for issuance in the transaction.

Fairness hearings are open to the public. It is possible, but unusual, for a competitor or another bidder to appear at the hearing and contest the fairness of the transaction—for example, by making a higher bid on the spot.

Non-Competition Agreements

Courts are sometimes reluctant to enforce non-competition agreements on the grounds that they are contrary to public policy. The enforcement of non-competition agreements in California is particularly problematic, because a California statute provides that non-competition agreements are unenforceable except in very limited circumstances, such as in connection with the sale of a business.

In addition, California courts generally will not enforce a non-competition agreement governed by the laws of another state unless the non-competition agreement would be enforceable under California law.

If a former employee against whom an out-of-state company seeks to enforce a non-competition agreement is a resident of California at the time enforcement is sought, this limitation can preclude enforcement in California of an otherwise valid non-competition agreement entered into when the employee resided in another state, even if the parties' contract expressly provided that the law of that state governed. Some California courts, however, have shown a willingness to enforce the parties' choice of law provision when it appeared that the former employee had moved to California in an effort to avoid his or her contractual obligations.

Stock Options

If any California residents are to receive options or other equity incentives, then the stock option or other equity incentive plan must comply with California law. For example, an option must be exercisable (to the extent vested) for at least six months following termination of employment due to death or permanent and total disability and, unless the optionee is terminated for cause, for at least 30 days following termination of employment for any other reason.

If a company does not wish to extend these rights to all plan participants, it can use a separate form of agreement containing the required provisions for California participants. California option and equity incentive plan requirements do not apply to a public company to the extent that it registers option shares with the SEC on a Form S-8.