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Do Top-Up Options Violate California's 50/90 Rule?

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Introduction

A top-up option is an option granted by the target corporation to the offeror in two-step negotiated corporate acquisitions. These transactions are structured as cash tender offers, typically for all of the outstanding shares of the target corporation, followed by a back-end merger. The back-end merger may be a long-form merger (in which case the target company will convene a shareholder meeting after the tender offer closes and have the shareholders approve the merger with the bidder) or, if the bidder holds over 90% of the target's capital stock after closing its tender offer and the applicable state law so permits, as a short form merger (in which case the merger will occur without the further involvement of the target board or shareholders).

The top-up option allows an acquiring company to purchase newly issued shares directly from the target corporation, which when added to the stock already owned by the offeror immediately after the tender offer constitutes more than 90% of the outstanding shares of capital stock of the target. As a result of the exercise of the top-up option, the offeror will be able to complete the short form merger.[1]

In two-step transactions, top-up options are used to expedite the completion of the second-step merger to avoid the costs and delay associated with a second step long-form merger. Because the long-form merger requires the preparation and filing with the SEC of a proxy statement (with a minimum ten day waiting period for the SEC to decide whether or not it will review the filing) and a stockholder meeting, it can take six to eight weeks to accomplish after the completion of the tender offer, at significant cost. By contrast, the exercise of the top-up option followed by a second step short-form merger can be accomplished in less than twenty four hours. By speeding up the merger timetable, the short-form merger enables faster payment to the target's shareholders.

Because of these substantial benefits, top-up options are routine features in negotiated tender offers. According to an American Bar Association study, 100% of acquisitions in 2008 by a non-controlling stockholder structured as two-step deals included a top-up option.[2] Since 1999, six of the seven tender offers for publicly-traded California corporations involving a second-step short-form merger included a top-up option,[3] including two transactions in which the top-up option was exercised in order to allow the acquirer to reach the 90% ownership mark.[4]

Delaware courts have had occasion to address the validity of top-up options in several merger cases and have generally approved their use provided certain process, scope, and disclosure requirements are met.[5] This article will not discuss those cases and their rulings, however. Instead, this article will focus on whether a top-up option is permissible in a transaction involving a target incorporated in California, a question which presents unique issues that do not exist under Delaware law.

The California Question

The question arises because of California General Corporation Law ("CGCL") section 1101(e) – a provision that has no equivalent in the law of other jurisdictions.[6] Section 1101(e) provides that shareholders of a target corporation involved in a merger with another party that owns more than 50% of the target's voting stock can only receive nonredeemable voting stock pursuant to the merger unless all such shareholders consent[7] or unless the Commissioner of California Corporations approves the transaction as fair (the so-called "50/90 Rule").[8] Specifically excluded from section 1101(e) are short-form mergers, which can be effected by an acquirer owning at least 90% of the shares of the target corporation,[9] and mergers of a corporation into its subsidiary in which it owns at least 90% of outstanding shares.

Section 1101(e) thus prevents an existing 50 to 90% shareholder from squeezing out the minority public shareholders from the ongoing enterprise. The most obvious application of 1101(e) is in the context of a "going private" transaction where the majority shareholder takes out a minority of the same class of stock using the company's cash. However, with two-step transactions becoming more frequent, plaintiffs have found a novel way to attack the top-up options in California, claiming that these options violate section 1101(e).

The validity of a top-up option came up recently in litigation relating to the acquisition of Actel Corporation (a California corporation) by Microsemi Corp. Plaintiffs sought to enjoin the tender offer for Actel's shares, in the eleventh hour, on the grounds that a top-up option given to Microsemi violated section 1101(e). While the court denied plaintiff's request for a temporary restraining order, it did not specify the basis for its ruling and therefore cannot be viewed as condoning the use of a top-up option in a tender offer for a California corporation.[10] The main question that has not yet been definitively resolved in California is whether top-up options violate section 1101(e) by depriving minority shareholders of their right to receive stock rather than cash when it allows a 50 to 90% bidder to effect a short form cash merger which the bidder would not be able to effect in the absence of the top-up option.

I. Overview of the Top-up Options and the Relevant Legal Landscape. Because the validity of the top-up options turns on the interpretation of section 1101, before delving into the application of section 1101(e) in earnest, a brief additional discussion of section 1101 and the key features of top-up options is warranted.

A. Section 1101(e) or the 50/90 Rule.
As noted above, section 1101(e), or the 50/90 Rule, is a unique provision in the U.S. corporate landscape. The legislative history demonstrates that section 1101(e) was enacted in the 1970's as part of the California Corporation Code reform aiming to boost minority shareholders' protections against the "tyranny of the majority" shareholders. The purpose of the provision was to prevent an existing majority shareholder from squeezing out the minority public shareholders from the ongoing enterprise, often referred to as "going private."[11] Whether section 1101(e) has served the interests of the minority shareholders or hurt them has been the subject of a substantial debate.[12] It has been argued that the 50/90 Rule does not in fact protect minority shareholders because it allows a single shareholder to block a cash deal that would have been beneficial to all.[13] It has also been noted that the standard of fairness that the Commissioner of California Corporations applies pursuant to section 1101.1 is not well defined, offering no guarantee to a controlling shareholder that it will be able to accomplish a desired transaction at an objectively fair price.[14]

While section 1101(e) has not been a popular statute, its implications are clear at least as far as some transactions are concerned. It precludes a cash or part cash/part stock buyout by a 50 – 90% shareholder. It also precludes a hostile takeover, unless a hostile cash tender offer is conditioned on the 2cquirer owning at least 90% of the target's outstanding shares immediately following the tender offer (and otherwise no more than 49.9% assuming it is willing to bear the costs and uncertainty of effecting a second step merger transaction despite the lack of majority ownership). The 50/90 Rule also inhibits a hostile acquiror's ability to resort to "street sweep" tactics or "creeping acquisition" strategies.[15]

By contrast, section 1101 does not inhibit the use of the cash merger as a technique for making a cash acquisition of another corporation in an arm's length transaction. Two unrelated corporations may effect a long-form merger with the shareholders of the target receiving cash in the transaction. There will have to be a majority vote of shareholders of the target corporation to approve the transaction, but since the acquiring corporation owns less than 50% of the outstanding shares of the target, the provisions of section 1101(e) will not be applicable.[16]

B. The Mechanics of Top-Up Options.
While the specifics of top-up options differ from transaction to transaction, top-up options generally include the following key features. First, a top-up option generally provides that it may be exercised only after the tender offer closes, which is typically conditioned upon, among other things, the acquiror owning a majority of the outstanding shares immediately following the tender offer. In many cases the top-up option will also provide that it may be exercised only if the offeror acquires a specified super-majority of the target's stock. This super-majority threshold is typically between 80% and 85% of the target's outstanding shares.[17] Alternatively, the merger agreement may condition the exercise of the top-up option on achieving the over 90% threshold when adding the shares already acquired and the top-up shares on a fully diluted basis after the exercise of the top-up option.

The number of shares available for a top-up option is determined by calculating the number of shares that would need to be purchased to enable the offeror to hold over 90% of the common stock after exercising the option. This number is limited by the amount of the target's authorized but unissued stock. As a rule, for every 1% that the offeror's tender offer falls short of 90%, the top-up option will require the target to issue that number of shares which is equal to 10% of its outstanding stock prior to the tender offer.[18] Therefore, as a practical matter, the top-up option is exercisable only once the offeror has acquired a substantial majority of the target's stock in the tender offer.

In addition to the various trigger and threshold provisions, the top-up option generally provides that it is exercisable at the same price as the tender offer price. Recent top-up options also include a provision stating that the shares issued in the top-up option as well as the consideration received in connection with the exercise of the option would not be considered in the determination of the fair market value of the stock in appraisal proceedings, thus eliminating the argument that top-up options dilute the stock and hurt the dissenting shareholders' appraisal rights.

II. Application of Section 1101(e) to Top-Up Options.

By definition section 1101(e) applies only to transactions by a 50-90% shareholder. An offeror in two-step transactions is an unrelated third party prior to entering into a merger agreement with the target (the first step of the transaction) or a 90%+ shareholder prior to the short-form merger (the second step of the transaction). Such an offeror, however, may become the target's 50-90% shareholder at the end of the tender offer and before exercising the top-up option. The validity of the top-up options under section 1101(e) therefore turns on when the 50-90% share ownership level is tested under the statute in two-step transactions. The literal reading of statute, the rest of the corporate statutory scheme and the legislative purpose behind section 1101(e), as discussed below, strongly suggest that the 50-90% ownership level in such deals is tested after the offeror's exercise of the top-up option (i.e. immediately before the short form merger) or, immediately prior to the parties' entering into the merger agreement, when the offeror is an unrelated third party.

Section 1101 By Its Terms Does Not Apply to Negotiated Transactions With a Third Party.

First, by its terms, section 1101(e) contemplates application only to situations where the offeror owns between 50 and 90% of the target immediately prior to the merger. *See* Cal. Gen. Corp. Law § 1101 (shares of the target "may be converted only into. . . common shares of the surviving party... if a constituent corporation or its parent owns. . . *prior to the merger*") (emphasis added). The statute thus literally tests the 50% ownership requirement immediately prior to the merger.[19] In a two-step transaction where a top-up option is exercisable, the only merger the offeror finds itself immediately "prior to," is the short-form merger after the offeror holds more than 90% of the target's stock achieved through the exercise of the top-up option. Thus, section 1101(e) prohibits a specific type of merger that is not implicated by tender offers with top-up options.

Similarly, if one considers the statute's goal to limit the ability of a majority shareholder to cash out the minority shareholders, the ownership level may be tested immediately prior to the parties entering into the merger agreement. There is some analogous support for this proposition. The California Supreme Court, interpreting section 1312(b), which provides that appraisal is not the exclusive remedy in a merger involving two corporations, one of which controls the other, affirmed the holding of the Court of Appeals that the determination of whether the acquiring corporation controlled the target company for purposes of section 1312(b) would be made immediately before execution of the merger agreement, not immediately before the time of the shareholder vote or consumption of the merger. *See Steinberg v. Amplica, Inc*., 42 Cal. 3d 1198, 1214-15 (1986).[20]

Either way, the statute does not appear to be concerned with two-step transactions where an unrelated bidder seeks to acquire all of the target's outstanding shares in the tender offer and is not contemplating any merger as a 50% to 90% stockholder.

- The Statute Does Not Limit The Means of Acquiring 90% Stake in a Company. Second, section 1101(e) does not define or limit the journey to acquiring a 90% stake in a company.
  It just prohibits a cash-out merger by a holder of between 50% and 90%. So, a 65% holder could enter into a series of private transactions with minority holders by virtue of which it acquires a stake of 90% or more.[21] Alternatively, an individual shareholder or a group of shareholders together owning 90% of the company's stock can avoid the 50/90 Rule by contributing their shares to a newly formed corporation which then effects a short-form merger. The majority shareholder also can transfer some of its shares to a sympathetic but unaffiliated party third party and thereby get beneath the 50% ownership threshold that triggers the 90% approval required of section 1101.[22] To conclude that a top-up option, as opposed to any other private purchase or transfer transaction designed to avoid the application of section 1101(e), is prohibited entails a more than expansive reading of the statute.

- Section 1101 Authorization of the Top-Up Options is Consistent with the Rest of the Corporate Statutory Scheme.
  Third, when read in conjunction with the CGCL as a whole it is apparent that section 1101(e) does not prohibit top-up options. The drafters of the CGCL knew how to identify unlawful evasions of section 1101(e) and did so. Thus to avoid the evasion of prohibition on cash consideration by issuance to the minority shareholders of redeemable preferred stock, which could be immediately redeemed for cash, the statute requires that only "nonredeemable common shares" be given to minority shareholders.[23]

Moreover, reading Section 1101 in conjunction with section 407 and section 1001(d) of the CGCL reveals that the Legislature is entirely capable of prohibiting certain kinds of transactions that could be perceived as an "artifice" to improperly circumvent section 1101's prohibitions. Section 407 allows payment of cash for fractional shares resulting from stock splits or reverse stock splits, but prohibits the payment of cash for fractional shares in any case where "such action would result in the cancellation of more than 10 percent of the outstanding shares of any class."[24] By this provision, acquisition through a reverse stock split with a payment of cash to all of the public minority shareholders is effectively prohibited in any case where the majority shareholder owns less than 90% of each class of outstanding shares of the corporation.[25] Likewise, section 1001(d) prevents a majority shareholder from effecting a cash-out merger by the sale of substantially all of the company's assets to a company controlled by the majority shareholder.[26] By contrast, nothing in the CGCL restrains the ability of the target corporation to issue stock to the potential acquirer to enable it to effect a short-form merger or that prevents a private shareholder's additional private stock purchases to effect the same.

In fact, section 404 expressly provides that a company has the right to provide an option to a third party to acquire the company's stock – precisely what a top-up option does. It is a well established rule of statutory construction that a statutory provision may not be interpreted to prohibit a right created by another provision of the statute unless expressly stated.[27] Accordingly, section 1101(e) should not be read to negate the right of a target to grant a tender offeror an option to purchase a target's shares.

- Almost All Two Step Transactions Are Acquisitions By Unrelated Third Party of 100% of the Target's Stock And Not "Going Private" Transactions.
  Finally, it is important to return to first principles and recall that the purpose of section 1101 is to prevent majority shareholders from squeezing out minority shareholders from the benefit of an ownership interest in the ongoing enterprise through a cash buy-out.[28] Almost all of the two-step transactions, however, are acquisitions by an unrelated party of 100% of the target's corporation stock for cash. In contrast to a "going private transaction," where a majority shareholder is getting rid of a minority for cash, the effect of a two-step transaction is for an independent third party to accomplish through a series of transactions a short-form merger, or a majority approved long-form merger for cash or cash and stock consideration.[29] Thus the underlying rationale of section 1101(e) does not support the conclusion that it must be read to prohibit widely-recognized measures that permit the speedy completion of the acquisition by one company of another in an arms-length transaction.[30]

Conclusion

In short, the express terms of section 1101(e), the legislative history behind its adoption, the surrounding corporate statutory scheme – all indicate that top-up options granted to unrelated third parties seeking to acquire 100% of the target's stock in two-step deals do not violate section 1101(e), even if by nature of the transaction the acquirer crosses the 50-90% shareholder level at the end of the first step of the transaction, prior to the exercise of the top-up option. Nothing in section 1101(e), or indeed the CGCL, prohibits a grant of a stock option to an unrelated third party acquirer, and the only "mergers" that occur in a two-step transaction, occur when the acquirer is either an unrelated third party (prior to entering into a merger agreement) or a 90%+ shareholder (prior to effecting a short-from merger). Nor can it be said that the spirit of section 1101(e) is violated by a grant of a top-up option to a third party acquirer, because unlike a majority shareholder, an unrelated third party acquirer can accomplish a cash merger through an alternative transaction - as a majority approved long-form merger for cash or cash and stock consideration. For these reasons, the use of top-up options in two-step acquisitions by an unrelated party should continue to be validated in California as a lawful and rational means for a third party bidder to provide the target's shareholders cash for their shares quickly.

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[1] A sample top-up option clause from the Agreement and Plan of Merger dated as of October 2, 2010, by and among Actel Corporation, Microsemi Corporation, and Artful Acquisition Corp., is set forth in Appendix A hereto. While top-up options now are almost universally set forth in the merger agreement, up until the early 2000', they could also be set forth in a separate stock option agreement.

[2] *See* American Bar Association Mergers & Acquisitions Market Trends Subcommittee, 2009 Strategic Buyer/Public Target Mergers & Acquisitions Deal Points Study at 106 (Sept. 10, 2009) ("M&A Deal Points Study").

[3] *See* the Solicitation/Recommendation Statement of Actel Corporation on Schedule 14D-9, filed with the SEC on October 4, 2010; the Offer to Purchase the shares of Laserscope dated June 14, 2006, attached as Exhibit (a)(1)(A) to the Tender Offer Statement on Schedule TO, filed by Laserscope with the SEC on the same day; the Offer to Purchase the shares of Genelabs Technologies, Inc. dated November 12, 2008, attached as Exhibit (a)(1)(A) to the Tender Offer Statement on Schedule TO, filed by Genelabs with the SEC on the same day; the Stock Option Agreement among the Coca-Cola Company, Perry Phillip Corporation, and Odwalla, Inc. dated October 29, 2001, attached as Exhibit 99.2 to Form 8-K filed by Odwalla with the SEC on November 2, 2001; the Offer to Purchase the shares of Creative Host Services, Inc. dated February 26, 2004, attached as Exhibit (a)(1)(A) to the Tender Offer Statement on Schedule TO, filed by Yorkmont 5, Inc. and Compass Group USA Investments with the SEC on the same day; the Offer to Purchase the shares of Xylan Corporation dated March 8, 1999, attached as Exhibit (a)(1) to the Tender Offer Statement on Schedule 14D-1, filed by Xylan with the SEC on the same day; compare to Offer to Purchase the shares of Clary Corporation dated December 17, 2002, attached as Exhibit (a)(1) to the Tender Offer Statement on Schedule TO, filed by Clary with the SEC on the same day (no top-up option, but the minimum tender condition was 90%).

[4] *See* Actel Corporation's Current Report filed on Form 8-K with the SEC on November 2, 2010; Amendment No. 6 to a previously filed Tender Offer Statement on Schedule TO relating to the offer to purchase the shares of Genelabs Technologies, Inc., filed by Genelabs with the SEC on January 7, 2009;

[5] For a recent discussion of Delaware law and top-up options, *see* J. Travis Laster and Matthew F. Davis, Catching Up on Top Up Options, 23 Insights at 8 (Jan. 2009) and In re Cogent, Inc. S'holder Litig., No. 5780, 2010 WL 3894991, at *11-14 (Del. Ch. Oct. 5, 2010) (upholding top-up option).

[6] Other states have enacted statutes regulating takeovers by majority shareholders. *See*, e.g., Control Share Acquisitions Chapter of the Indiana Business Corporation Law, Ind. Code §§ 23-1-42-1 to -11 making the voting rights of "control shares" in covered Indiana corporations subject to a majority vote of all shareholders other than the acquiring person and incumbent management. The California statute limiting the type of consideration to be paid to minority shareholders or requiring a unanimous shareholder consent appears to be unique.

[7] Cal. Corp. Code § 1101.

[8] Cal. Corp. Code § 1101.1.

[9] *See* Cal. Code § 1110.

[10] *See Sullivan v. Actel Corp*., No. 1:10-cv-184257 (Santa Clara County Super. Ct.) (Nov. 1, 2010) (order denying plaintiff's motion for TRO).

[11] *See* Enrolled Bill Memorandum to Governor from Assemblyman John T. Knox regarding Assembly Bill 2849 (first "clean-up" bill) amending Section 1101 (e) (Aug. 25, 1976) (the last sentence to Section 1101(e) was added to prevent "the 'cash-out' of minority interests without their consent, in instances in which the parties to a merger are under common control"); 2 Harold Marsh, Jr., et al., MARSH'S CAL. CORP. L. § 19.05 (4th ed. 2010) ("[Section 1101] was primarily intended to restrict the cash-out of minority public stockholders.") ("Marsh").

[12] Interestingly, the minority shareholder protections contained in section 1101(e) do not appear in the initial drafts of the California Corporations Code reform that were submitted for recommendation to academics and practitioners and have been subject to substantial commentary. Instead, these provisions were part of the subsequent "cleanup bills" enacted as a result of political considerations and did not have the benefit of public commentary. *See* Samuel C. Dibble, Mergers and Asset Sales in California: Wants to be a Majority Shareholder, State Bar of California Business Law News, Dec. 2007 ("Dibble").

[13] *See id*; Lou R. Kling & Eileen T. Nugent, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, § 4.07[2][b] at 4-153 (1995) ("Kling & Nugent").

[14] *See* Dibble, supra.

[15] John F. Seegal, et al., Certain Legal Considerations In the Merger Or Acquisition of a California Corporation, 1257 PLI / Corp. 635 (2001) ("Seegal").

[16] *See* Marsh § 19.05.

[17] *See* M&A Deal Points Study at 108.

[18] *See* Mark A. Morton & John F. Grossbauer, Top-Up Options and Short Form Mergers, Deal Points, Apr. 2002, available at http://www.potteranderson.com/news-publications-40-54.html.

[19] *See* Kling & Nugent § 4.07[2] at 4-153 n.91; *see* also Dibble (Section 1101 does not have a look back provision – the test is applied at the time of the shareholder vote.).

[20] *See* Kling & Nugent § 4.07[2] at 4-153 n.91.

[21] *See* Dibble (suggesting this and other alternative approaches for a majority shareholder to cash out its holdings).

[22] *See id*.

[23] *See* Marsh § 19.05.

[24] A reverse stock split is the reduction in the number of shares outstanding when a corporation calls in its stocks and reissues a smaller number. A stock split is the issuing of a number of new shares in return for each old share without changing the proportional ownership interest of each shareholder. Black's Law Dictionary, ed. 1996.

[25] *See* Marsh § 19.05.

[26] *See id*.

[27] *See McLaughlin v. State Bd. of Educ*., 75 Cal. App. 4th 196, 211 (1999) ("An interpretation that renders related provisions nugatory should be avoided."); *Jurcoane v. Superior Court*, 93 Cal. App. 4th 886, 893 (2001) ("We must read statutes as a whole, giving effect to all their provisions, neither reading one section to contradict others or its overall purpose, nor reading the whole scheme to nullify one section. .. . '[A]ll parts of a statute should be read together and construed in a manner that gives effect to each, yet does not lead to disharmony with the others.'") (citation omitted).

[28] *See id*.

[29] While the exact contours of the universe of transactions that people have in mind when they refer to "going private transactions" are not always clear, many commentators would not view the two-step transaction as a "going private transaction." *See* Kling & Nugent § 4.07 n.1. The SEC also takes the view that two-step acquisitions are not subject to its special disclosure obligations applicable to going private transactions by an issuer or its affiliate. *See id*; *see* also SEC Rule 13e-3 (excluding from the definition of an "affiliate" "a person who is not [directly or indirectly in control of an issuer] at the commencement of such person's tender offer").

[30] In a friendly acquisition transaction where the parties desired to follow a two-step strategy, the grant of a top-up option to the acquirer was generally recommended to ensure that if less than 90% of the target's shares are tendered, the acquiror nevertheless can exercise the option and purchase enough shares to cross the 90% threshold. *See*, e.g., Seegal.

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