Upsetting Mergers and Consolidations: Alternative Remedies of Dissenting Shareholders in California

THE unanimous consent of shareholders has generally been held necessary to authorize such fundamental changes in corporate charters as a merger or consolidation, a sale of the entire assets, or amendments changing preference rights, in the absence of statute.[1] Thus any small shareholder, regardless of motive, could thwart the will of all the rest and object to changes merely to be bought off at his nuisance value. Since corporations cannot remain static in the struggle for existence through the ups and downs of business cycles, such a situation was obviously intolerable.[2]

Under modern corporation acts wide powers are given to the directors, acting with the approval of some specified majority of shareholders, to authorize various adjustments of the corporate contract to the changing needs of the business in spite of the opposition of the minorities.[3] The shareholder's contract, as part of the charter contract, may now be terminated or transmuted by dissolution, fundamental amendments of the articles, sales of the entire assets for shares of stock, and by merger or consolidation. At the same time the discretionary statutory power, unlimited in terms, to readjust the stock structure and to terminate, expand, or reorganize the corporate enterprise, is held subject to certain implied limitations of good faith against discrimination and the oppression of the minority. It is, however, rhetorical exaggeration to call these restrictions on abuse of power a "fiduciary" obligation owing by the majority "as trustees" to the minority.

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1 Garrett v. Reid-Cashion Land etc. Co. (1928) 34 Ariz. 245, 270 Pac. 1044; Whicher v. Delaware Mines Corp. (1932) 52 Idaho 304, 15 P. (2d) 610; 6 FLETCHER, CYCLOPEDIA OF CORPORATIONS (Perm. ed. 1931) § 2947; 13 *ibid.* §§ 5797, 5891; SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, (1931) 367, 374; Bisbee, *Consolidation and Merger* (1929) 6 N. Y. U. L. Q. REV. 404, 408; *cf.* Warren, *Voluntary Transfers of Corporate Undertakings* (1917) 30 HARV. L. REV. 335, 353.

2 Perry v. Bank of Commerce (1917) 116 Miss. 838, 855, 77 So. 812, 814; Dodd, *Dissenting Stockholders and Amendments to Corporate Charters* (1927) 75 U. OF PA. L. REV. 585, 589, 723, 728, 752; Lattin, *The Minority Stockholder and Intracorporate Conflict* (1932) 17 IOWA L. REV. 313, 321-331.

3 Chicago Corp. v. Munds (1934) 20 Del. Ch. 142, 149, 172 Atl. 452, 455; Hills, *Consolidation of Corporations by Sale of Assets and Distribution of Shares* (1931) 19 CALIF. L. REV. 349. The California statutes failed to provide for the merger or consoli-

There is a strong policy to facilitate business transactions and allow the majority to make full and effective use of their statutory powers. They may consult their own interests at least equally with those of minority holders. Majority rule is not established for the special benefit of the minority. The action of the directors and the majority shareholders, although they be adversely interested, is binding within the wide limits of an honest business discretion.[4] A rigid judicial requirement of proof of the utmost fairness in the exercise of majority powers, even where interests conflict, would place an impractical burden on the conduct of business and on legitimate policies of the majority. The minority are equally under a duty with the majority not to sabotage the joint enterprise. The rights of each shareholder must be adjusted to the interests of all.

This article aims to discuss briefly the difficult problems arising from unjustifiable suits to upset mergers or consolidations brought by piratical minorities and the system of limited alternative remedies which has been provided for dissenting shareholders in California corporations to safeguard the right of merger and consolidation on the part of majority shareholders. This is of special interest in view of the novelty of the provision of the California General Corporation Law[5] making the statutory appraisal and retirement of dissenting shares a remedy exclusive of irresponsible individual attempts to upset an entire merger or consolidation, and a recent decision of the federal Circuit Court of Appeals for the Ninth Circuit where this provision was first judicially considered.[6] How far does the California

dation of business corporations generally until 1929. Cal. Stats. 1929, c. 711. The provision for compensation of dissenting shareholders was added by Cal. Stats. 1931, p. 1817. It was not until 1931 that the New Jersey corporation law was amended to authorize sale of the entire assets. N. J. Laws 1931, c. 288, N. J. REV. STAT. (1937) § 14:3-5.

[4] Macfarlane v. North American Cement Corp. (1928) 16 Del. Ch. 172, 181, 157 Atl. 396, 399; Allaun v. Consolidated Oil Co. (1929) 16 Del. Ch. 318, 147 Atl. 257; Cole v. National Cash Credit Ass'n (1931) 18 Del. Ch. 47, 55-64, 156 Atl. 183, 187-190; Voigt v. Remick (1932) 260 Mich. 198, 244 N. W. 446; Robotham v. Prudential Ins. Co. (1903) 64 N. J. Eq. 673, 689, 53 Atl. 842, 848; Armstrong v. Hayden (1926) 126 Misc. 786, 787, 214 N. Y. Supp. 747, 749; Cleary v. Higley (1934) 154 Misc. 158, 277 N. Y. Supp. 63, *aff'd*, (1935) 246 App. Div. 698, 284 N. Y. Supp. 989. *Cf.*, however, Jones v. Missouri-Edison Elec. Co. (C. C. A. 8th, 1906) 144 Fed. 765; Berle, Jr., *Corporate Powers as Powers in Trust* (1931) 44 HARV. L. REV. 1049, 1069-1072. See 13 FLETCHER, *op. cit. supra* note 1, § 5811; 16 *ibid.* § 8022; BALLANTINE and LATTIN, CASES AND MATERIALS ON CORPORATIONS (1939) 77, n., 167-168, 284, 288-290; Wood, *The Status of Management Stockholders* (1928) 38 YALE L. J. 57, 72.

[5] CAL. CIV. CODE § 369 (17). See *infra* note 17.

[6] Beechwood Securities Corp., Inc. v. Associated Oil Co. (C. C. A. 9th, 1939) 104 F. (2d) 537. The authors of this article filed a brief as *amici curiae* in that appeal in exposition and support of the California provision which they had participated in drafting.

provision limiting the rights of dissenting shareholders go, and what is its purpose?

ABUSES OF POWER BY THE MAJORITY

By way of introduction and to present first the claims of champions of the minority, it will be helpful to refer to the extensive investigation and remarkable report of the Securities and Exchange Commission.[7] This report deals ably with various predatory corporate practices and the need of protection of investors against exploitation by controlling interests, sometimes found in plans for readjustment of capital structure, particularly those designed to eliminate arrearages of accumulated dividends on preferred stock. Similar abuses are found in connection with mergers, consolidations, and sales of entire assets for stock, referred to as "voluntary reorganizations."

As is pointed out in this report,[8] under virtually all the statutes control over the drafting of the terms of agreement for the exchange of securities in a merger or consolidation or sale is vested in the boards of directors of the constituent corporations subject to approval by the shareholders.[9] If the controlling majority has interests conflicting with the interests of some class of the shareholders, or of some constituent corporation, this is apt to result in the drafting of an unfair agreement. None of the statutes provides for an independent supervision or for impartial representation of the shareholders' interests. Only a minority of the statutes have provision for a vote by classes of shares or by shares otherwise restricted as to voting, as provided under the California law.[10]

The requirements as to notice to shareholders of meetings at which an agreement of consolidation or merger is to be voted upon are generally inadequate both as to time and content of notice, the usual period being twenty days as in California.[11] Even shorter periods are allowed in several states. These notices, like those provided in connection with sales of assets and charter amendments,[12] fail to afford

[7] Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VII, Management Plans Without Aid of Committees (May 10, 1938). This report will be hereinafter referred to as S. E. C. Report VII. See also Note (1939) 52 HARV. L. REV. 1331.

[8] S. E. C. Report VII, 1-11, 530, 556, 568, 588.

[9] CAL. CIV. CODE §§ 343, 361 (1).

[10] *Ibid.* §§ 361 (3), 362a.

[11] *Ibid.* § 361 (3).

[12] *Ibid.* §§ 312, 314, 343.

shareholders sufficient time and information to vote intelligently on the proposed action. The explanation of this apparently shocking inadequacy as to statutory notices no doubt is found partly in the fact that shareholders, by reason of inertia and preoccupation with other affairs, will seldom if ever use an opportunity to take any interest or action in the matter even if sufficient time, notice, and information are given.[13] Moreover, short notices are necessary from the practical viewpoint of enabling corporations to make proper underwriting arrangements for merger securities, it being normally impossible to get underwriting commitments for any great length of time. Such underwriting would ordinarily be necessary to insure the success of the merger. "Catching the market" is said to be one of the trickiest problems in merger finance.

The Securities and Exchange Commission report gives several scandalous case histories showing in detail how the controlling interests in corporations have abused their powers to the injury of helpless investors, as in the case of the expansion of The Equity Corporation.[14]

In Appendix B of the report[15] there is a summary of the law, supplementing the case histories in the earlier parts of the report with a discussion of the legal and equitable remedies available, aimed to show the lack of adequate protection of investors under existing laws against overreaching by a controlling group. The report concludes that both equitable and statutory remedies are inadequate, and that some more effective method of regulation of the various types of voluntary reorganization needs to be devised.[16]

The Commission report criticizes the provision found in the California General Corporation Law[17] making the statutory remedy of appraisal and compensation exclusive of individual attacks on mergers and consolidations as follows:

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[13] Meck and Cary, *Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935* (1938) 52 HARV. L. REV. 216, 245, 246; Note (1939) 33 ILL. L. REV. 914, 915.

[14] In the Matter of Equity Corp. (1937) 2 S. E. C. Dec. 675; S. E. C. Report VII, 199, 309-352; Note (1939) 27 GEO. L. J. 1092, 1104, "Before the merger the preferred shareholders had been entitled to approximately $9,800,000 upon liquidation, but after the merger their preference in this respect dropped about $3,600,000 to $6,200,000. . . ." Dividend preferences were reduced and dividend arrearages of about $4,000,000 were eliminated.

[15] S. E. C. Report VII, 462-610.

[16] *Ibid.* at 195-197, 342-352, 542, 590-610.

[17] CAL. CIV. CODE § 369 (17): "The rights and remedies of any shareholder at law or in equity to object to or litigate as to any such merger or consolidation shall be and are hereby limited to the right to receive the fair market value of his shares in the man-

"The effect of such provisions is to enable the management group, with the support of the majority stockholders, to ride rough shod over the dissenting minority upon payment of the appraised value of the dissenting stock. The dissenter may thus be confronted with the unattractive choice of submitting to a grossly inequitable plan or disposing of his investment in the company at a price fixed pursuant to the appraisal statute. Plans deliberately designed to 'squeeze out' a minority interest are more likely to succeed under a statute which limits dissenters to the single alternative of selling out."[18]

One may well doubt whether those who prepared this part of the report for the Commission had sufficiently studied the possible remedies available under the California provision or had taken sufficient time to consider and weigh the difficult problem of how to protect the majority against outrageous extortion and obstruction by "strikers." In other portions of the report it is clearly pointed out that the so-called "equitable" remedies are not now effective to prevent a management group, with the support of the majority shareholders, from riding rough shod over dissenting minorities.[19] The report recognizes that these equitable remedies involve the shareholder in the "uncertain and costly processes of litigation"[20] only available when he can prove fraud, bad faith, or flagrant unfairness, and raise serious difficulties of proof and intricate valuations. Practically the only remedy of which shareholders have been deprived is a right of action to attempt to upset the entire transaction for fraud. Does it then appear that the California and Michigan provisions for statutory cash compensation deprive a bona fide minority of any relief needed for their protection?

STRIKE SUITS

The California provision was drafted by a state bar committee of representative lawyers as a means of satisfying dissenting minorities and at the same time permitting legitimate consolidations and mergers

ner and upon the terms and conditions provided in this section, except actions to test whether the number of legal votes of shareholders required by statute to authorize or approve the proposed action of the corporation has been given."

The Michigan General Corporation Act of 1931 provides that the dissenter's right of appraisal and compensation shall be his exclusive remedy both as to merger and consolidation and also as to sale of all of its assets. MICH. GENERAL CORPORATION ACT (1931) §§ 44, 54.

18 S. E. C. Report VII, 609-610.

19 *Ibid.* 543, 546-556, 610.

20 *Ibid.* at 610.

without unlimited litigation at the instance of piratical obstructionists. The evils arising from abuse of equitable remedies, which the courts have been impotent to prevent, call for some radical departure from the system of regulation and remedies now generally prevailing. The problem of curbing extortionate corporate litigation while retaining or devising adequate protection for bona fide investors is well discussed in a note in the *Columbia Law Review.*[21] This note gives a brief description of that most notorious of professional strikers, the late Clarence H. Venner, as follows:

"The characteristics of strike suits may be illustrated by the activities of Clarence H. Venner, referred to as 'an artificer of litigation and a menace to corporate society.' Continental Securities Co. v. Belmont, 183 Misc. 340, 343, 144 N. Y. Supp. 801, 804 (Sup. Ct. 1913). During his career he conducted at least 23 campaigns against such defendants as the United States Steel Corp., the Great Northern Railway Co., the Interborough Rapid Transit Co., the American Telephone and Telegraph Co. These campaigns involved at least 40 separate actions and have left over 100 cases in the reports. The campaign against the New York Central extended over 14 years, involved 12 suits in 4 jurisdictions, employed 4 nominal plaintiffs, left 29 cases in the reports, and reached the United States Supreme Court 5 times. Of the total number of actions brought he lost 34 and won 5, one having been discontinued. This, however, is no measure of his success. He received $300,000 for $70,000 worth of Union Pacific Railroad stock (see N. Y. Herald Tribune, June 26, 1933, at 13); between one and two million dollars was his price for dismissing the suit against the Great Northern Railway Co. [A HISTORY OF THE LIBEL SUIT OF CLARENCE H. VENNER AGAINST AUGUST BELMONT, (published by the Interborough Rapid Transit Co., 1913) 136]; and he received 'a large sum' to discontinue against the Chicago, R. I. and P. Ry. Co. (*id.* at 123-128). Moreover, it is known that he brought many other actions which do not appear in the reports, an indication of success (*id.* at 141)."[22]

In an article entitled "Stockholders' Suits: A Possible Substitute,"[23] Mr. Harris Berlack points out: "There are individuals in plenty who will seize upon any slight irregularity as the basis for a charge of fraud,

[21] Note (1934) 34 COL. L. REV. 1308.

[22] *Ibid.* at 1308, n. 1. See also discussion of the evils of strike suits in the following: BURTCHETT, CORPORATION FINANCE (1934) 305, 307; DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 1135-1139; SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION (1917) 202-203.

[23] (1937) 35 MICH. L. REV. 597, 604.

capture any wisp of smoke and attempt to fan it into flame, begin a stockholders' action and set off the accompanying fireworks—and indicate, tactfully or otherwise, that their stock may be purchased at a price, and the suit withdrawn. Although there may be no basis whatsoever for the action, these tactics may nevertheless be successful; the corporation and the accused directors may find the cost and labor of defense more burdensome than the price of settlement, or the publicity accompanying a litigation more offensive than the unpleasantness of yielding to groundless threats. But even where there are substantial grounds for the charges and the threats carry the compulsion of possible execution, if the stockholder is willing to 'sell out' instead of pressing the advantage for the benefit of the corporation, his actions are still classified as strike tactics."

In an article by Roscoe Pound, "Visitatorial Jurisdiction Over Corporations in Equity"[24] it is said: "There is no need to recite the difficulties involved in stockholders' suits for mismanagement. These suits have been abused quite as much as the powers of directors they have intended to restrain.... If the interests of the investing public can be secured through courts of equity in some other way not involving these abuses and limitations, the gain for economic security is obvious."[25]

THE CALIFORNIA LIMITATION OF REMEDIES

At first sight it may seem to many to be palpably unjust to minority shareholders to confront them with a statutory alternative of accepting new securities which they may regard as grossly inadequate in value or amount, according to a merger or consolidation agreement drafted by others, or of seeking to obtain the fair market value of their shares by agreement or as determined in appraisal proceedings.[26] On the other hand, however, it may be pointed out that the dissenting shareholder will be obliged to indulge in much more burdensome litigation in order to persuade an equity court to enjoin or set aside a merger on the ground of fraud or unfairness and in the process he will

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[24] (1936) 49 HARV. L. REV. 369, 395.

[25] In Windhurst v. Central Leather Co. (1927) 101 N. J. Eq. 543, 551, 138 Atl. 772, 776, a merger case, Bentley, V. C., remarked: "There is no use in mincing words.... While I cannot say that Windhurst is a '*professional* privateer,' as the vice-chancellor said of Clarence Venner, still, it would seem from a mere statement of the circumstances of his expedition into the troubled sea of the defendants' affairs that his venture was not entirely free of a piratical character." See also General Inv. Co. v. Lake Shore Ry. (1922) 260 U. S. 261, 289; S. E. C. Report III, Committees for the Holders of Real Estate Bonds (June 3, 1936) 230-238.

[26] Dodd, *op. cit. supra* note 2, at 734-737.

inflict needless loss on himself and others. The desirability of making appraisal of the shares exclusive of irresponsible attacks to set aside a consolidation or merger is at least a fairly debatable measure, a question of legislative policy in devising forms of remedies which will not unduly hamper and threaten the transaction of legitimate business.

In an able article,[27] Professor N. D. Lattin says: "The small stockholder should not be permitted to retard desirable action.... But legislation of the California type is too sweeping and takes into account only the corporate interest as represented by the majority. No majority, however large, should be permitted to run rough shod over the minority, however small, by illegal action or legal action carried out by illegal means."[28]

It may be replied that no minority of dissentients, however small, should be permitted to obstruct the right to enter a merger and consolidation in bad faith or on groundless charges of fraud or for purposes of blackmail and extortion against a majority, however large. Care must be taken that the overwhelming majority of the shareholders are not deprived of their rights by the few dissentients.[29] Professor Lattin fails to explain how he would obviate the abuses of minority litigation which work undue hardships and obstruction on the majority. He admits in his article that until recently the conflict between the majority in carrying out their policies and the minority has been "too one-sided in favor of the individual stockholder. Now the pendulum is swinging the other way, perhaps too rapidly. The stress is upon group action, and rightly so.... It is quite possible that the intricacies of the situation may eventually require some group action on the part of the minority so that action by the majority of the minority, or by some designated proportion, will bind them. . . ."[30]

This suggestion of ascertaining a "majority of the minority" seems entirely impracticable. Who are the minority? Those who voted against the merger? Those who did not vote for it? Those who actively dissented and demanded compensation? Those who voted against it but now are willing to take securities in the reorganized company? Those who were deceived into voting for the merger or who now wish to change their minds? How could one ascertain the wish of "the majority of the minority" except by a receivership?

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27 *Remedies of Dissenting Stockholders under Appraisal Statutes* (1931) 45 HARV. L. REV. 233, 245.

28 See also STEVENS ON CORPORATIONS (1936) 498-499.

29 Bingham v. Savings Inv. & Trust Co. (1927) 101 N. J. Eq. 413, 138 Atl. 659, *aff'd*, (1928) 102 N. J. Eq. 302, 304, 140 Atl. 321, 322.

30 Lattin, *op. cit. supra* note 27, at 248.

The California provision as to dissenting shareholders[31] came before an appellate court for the first time in *Beechwood Securities Corporation, Inc. v. Associated Oil Company.*[32] The circuit court of appeals in this case denied Beechwood, a dissenting shareholder, the equitable remedy of upsetting and declaring null and void the merger of two subsidiaries into the Tidewater Associated Oil Company. Beechwood, a small dissenting shareholder holding 260 shares in the Associated Oil Company, brought the suit on behalf of himself and other shareholders similarly situated. It was instituted after the consummation of the merger although this did not appear clearly on the face of the complaint.[33] The parent corporation, the Tidewater Associated Oil Company of Delaware, owned over ninety-eight per cent of the issued shares of the Associated Oil Company, a California corporation, and over ninety-nine per cent of the issued shares of the Tidewater Oil Company, a Delaware corporation, the other subsidiary. Only forty thousand shares out of a total of 2,290,412 shares of Associated were outstanding in the hands of the general public and complainant owned only about one-hundredth of one per cent of the issued shares. Even out of the forty thousand shares in the hands of the general public complainant only owned six-tenths of one per cent. There were no other dissenting shareholders before the federal court, but some other dissenters were suing at the same time under the appraisal statute for the fair market value of their shares in the state court.[34]

The grounds upon which relief was sought in the *Beechwood* complaint upon what was basically a corporate cause of action were in substance as follows:

(1) That the defendant Tidewater Associated Oil Company was under a trust obligation to complainant and other minority shareholders of its subsidiary, Associated Oil Company, by virtue of the parent and subsidiary relation of control. The transaction was accordingly

[31] CAL. CIV. CODE § 369 (17).

[32] *Supra* note 6. The ninety days allowed for certiorari applications have not expired at present writing.

[33] It appeared in the complaint that the merger agreement had been approved by the shareholders of the three constituents. In addition the record contains, by the request of appellant's own *praecipe*, a verified petition of the appellee setting forth clearly that all of the necessary merger proceedings had been taken and all of the necessary documents filed with the secretary of state by November 30, 1936, at least three weeks before the suit was filed. The court had thus ample justification to consider the merger in the Beechwood case as consummated even if there was some vagueness in the complaint.

[34] Heller v. Associated Oil Co., #273495, In the Superior Court of the City and County of San Francisco.

claimed to be voidable at the election of any minority shareholder, as in case of a contract by a trustee with himself, because the terms of the transaction were dictated by the parent corporation to its subsidiary for its own benefit.[35]

(2) That the proceedings constituted the confiscation and taking of private property of the minority shareholders for private purposes without due process of law and without making just compensation therefor in violation of the Fifth and Fourteenth Amendments to the Federal Constitution, in that the California statute deprived the complainant of equitable remedies to have the merger declared void because of the domination of the parent corporation over the subsidiary and its discrimination against Associated shareholders.

(3) Assuming that the limitation of equitable remedies was void, that the merger should be annulled because the terms were unfair to the minority shareholders in Associated in that the rate of exchange (two and one-fourth shares in the surviving corporation for one share in Associated) provided an inadequate equivalent for Associated shareholders as compared with Tidewater shareholders who received three shares for one.[36]

(4) The fourth ground of objection was a minor and technical one, that the transaction was in reality not a merger but a sale of assets to the parent corporation upon terms fixed by the purchaser, which was not carried out under the provision of California Civil Code section 343 as to sales of entire assets.[37]

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[35] It is not in general the rule that common control makes intercorporate transactions voidable at the option of a minority shareholder of a subsidiary corporation. Voigt v. Remick, *supra* note 4; Helfman v. American Light & Traction Co. (1936) 121 N. J. Eq. 1, 16, 187 Atl. 540, 548; Cleary v. Higley, *supra* note 4, at 170, 277 N. Y. Supp. at 77-78. A few jurisdictions hold otherwise. Alabama Fidelity Mort. & Bond Co. v. Dubberly (1917) 198 Ala. 545, 73 So. 911; Glengary Consol. Min. Co. v. Boehmer (1900) 28 Colo. 1, 62 Pac. 839 (absurd rule that every contract of a parent corporation with its subsidiary is voidable at the option of any minority shareholder in the subsidiary without proof of fraud or unfairness). *Cf.* CAL. CIV. CODE § 311.

[36] The book values as set forth in the complaint were of little significance as prospective earnings are a more important factor. The complaint failed to set forth the relative earning capacities but mentioned only the average earnings for an unnamed period. The valuation of the assets of Associated was attacked as arbitrary and as omitting any item of good will and as based on excessive rates of depreciation and depletion af assets.

[37] The purpose of this trumpery contention was to get complainant out from under the restrictive provisions of section 369 (17) of the Civil Code, which does not apply to sales of assets in California corporations. *Cf.* Havender v. Federal United Corp. (Del. Ch. 1939) 6 A. (2d) 618, superseding opinion (Del. Ch. 1938) 2 A. (2d) 143, where a nominal merger of parent and subsidiary corporations was used for the purpose of amending the certificate of the parent to evade limitations on the amending power in

The complaint was not framed as an attack upon sufficiency or regularity of the merger proceedings or on the ground that the requisite number of legal votes was lacking, but was in substance an attempt to upset a completed merger on the ground of inadequacy of the ratios of exchange of stock; namely, that the agreement did not provide for a sufficient number of Tidewater Associated Oil Company shares in exchange for the Associated Oil Company shares. In order to make this attack upon the exercise of power by a two-thirds majority of all classes of shares the complaint challenged the constitutionality of the statutory provision imposing limitations upon the remedies of dissenting shareholders except to test the number of legal votes and formal compliance with the merger provisions.

The Tidewater Associated Oil Company moved to dismiss the complaint on the ground that California Civil Code section 369 provided a plain and adequate remedy for dissenting shareholders; that this section provided an exclusive remedy, and that the fraud allegations amounted to no more than a controversy over the value to be placed on complainant's 260 shares. Any charges of fraud or unfairness were admitted only for purposes of demurrer to test their sufficiency in law. The district court dismissed the complaint without leave to amend. The circuit court of appeals affirmed the decree of dismissal, in spite of an informal offer to amend the bill at the hearing in the district court and on appeal, the court taking into consideration whether, if permitted, an amended bill would warrant the relief prayed for. The circuit court of appeals held that a state legislature may constitutionally substitute compensation for equitable suits to avoid and annul mergers and consolidations either in state or federal courts. It refused, however, to pass on a question suggested by the court itself as to the true construction of the California statute. Complainant was held barred by laches from raising this question since the case had been argued in the court below and in the appellate court on the basis that the effect of the California statute, if constitutional, was to exclude equitable suits to rescind a merger for fraud.

The following quotation from the court's opinion in the *Beechwood* case[38] will assist in an understanding of the case:

"The case was argued below and here on the theory that paragraph (17) of section 369 of the Civil Code . . . gave no right at law or in equity to

order to eliminate arrears of cumulative dividends on preferred shares of the parent. See *infra* note 66.

[38] *Supra* note 6, at 539-540.

the non-assenting shareholder other than to accept the corporation's offer or sue for the fair market value, save that he could contest the consent or approval of the necessary two-thirds of the shareholders to the proposed consolidation agreement.

"In effect, Beechwood contends that a state cannot so organize its corporations that a shareholder, not assenting to such a consolidation, may not show, in equity, that the proposal for exchange of his shares for those in the consolidated corporation is made with intent to defraud and will defraud him. . . .

"In effect, these code sections, as construed by both parties, say to a shareholder, 'When you buy stock in a California corporation you are advised that your associate shareholders holding two-thirds of the shares may consolidate your corporation with another into a third corporation, offer you what they please of its shares in exchange for those you hold, and, if you do not like the offer, may buy out your shares at their fair market value at the time they vote the consolidation.'

"The corporation and its shareholders' rights are mere creations of the state of incorporation and we can see no reason why such incidents of a shareholder's interest as provided in the pertinent sections of the corporate law of California are beyond its legislative power. Beechwood has cited no case denying such power in a state legislature in giving form to its corporate creature. There is no underlying 'natural right' of a shareholder in a corporation to follow his investment into a consolidated corporation. May v. Midwest Refining Co., D. C. Me., 25 F. Supp. 560, 564. The legislature may terminate a shareholder's investment on payment of its then face value, if it so choose.

"No fraud warranting the setting aside of a consolidation is committed on the shareholder when he receives the exact treatment the statute advised him was his due when he invested in the shares. Mayfield v. Alton Ry., etc. Co., 198 Ill. 528, 65 N. E. 100, 101; Kirby v. Saginaw Hotels Co., 253 Mich. 308, 235 N. W. 153. Hence there is no denial of an equitable remedy. Since the shareholder has no underlying legal right to pursue his investment, he has no ground upon which relief in equity can be granted. Cf. Union Pacific R. Co. v. Board of Commissioners, 8 Cir., 222 F. 651, 654, 659. . . .

"What we here hold is based on the assumption of both parties, here and below, that the legislature in the Civil Code sections created such an incident of corporate shares.[39] We thought it might be contended that the legislation could be construed otherwise and ordered argument and briefs relative to such a contention. Associated objected to its consideration on the ground of laches, urging the completion of the consolidation over two years before and the injustice of disturbing the vast and complicated interests of the consolidated companies because of a contention which the dissentient shareholder had not raised. We deem the objection well taken."

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[39] *I.e.*, a contract making the appraisal remedy exclusive of the equitable remedies whieh required a dissenting shareholder to accept the terms of exchange offered by the agreement of merger or else accept the fair market value of his shares.

The court is entirely correct in holding that a dissenting shareholder has no constitutional right to any particular form of remedy against abuse of power, such as the specific relief of rescission, especially where the interests of many other parties are involved. As it is pointed out by the United States Supreme Court in the case of *Neblett v. Carpenter*:[40]

> "The petitioners have no constitutional right to a particular form of remedy. [Gibbes v. Zimmerman (1933) 290 U. S. 326, 332; Doty v. Love (1935) 295 U. S. 64, 70.] They are not entitled, as against their fellows who prefer to come under the plan and accept its benefits, to force, at their own wish or whim, a liquidation which under the findings *will not advantage them and may seriously injure those who accept the benefit of the plan.* They are not bound, as were the dissenting creditors in *Doty v. Love,* 295 U. S. 64, to accept the obligation of the new company but are afforded an alternative whereby they will receive damages for breach of their contracts. They have failed to show that the plan takes their property without due process."

In the *Neblett* case several non-consenting policy holders in the Pacific Mutual Life Insurance Company sought to restrain the operation of a rehabilitation and liquidation plan proposed by the state insurance commissioner which involved the transfer of assets to a new corporation and the substitution of a policy in the new company.

The constitutionality of a statute authorizing merger and consolidation does not depend upon offering the shareholders an option of remedies to litigate fraud and unfairness of such exchanges and set aside completed transactions on the one hand with the alternative to retire and receive compensation for the value of their shares on the other. Statutes as to appraisal and compensation do not give this remedy on the theory that compensation is awarded as an incident of the exercise of the power of eminent domain, as has sometimes been supposed. The compensation of dissenting shareholders is not paid on the theory that the shares of the dissenters are being taken for public use even in the case of a railroad or public utility. Cases which uphold the constitutionality of consolidation or merger statutes on this ground are based on a wrong theory.[41] Statutes authorizing fundamental changes in the corporate organization are based on the reserved power to alter and

[40] (1938) 305 U. S. 297, 305. (Italics added.) See also COOLEY, CONSTITUTIONAL LIMITATIONS (7th ed. 1903) 515-516.

[41] Spencer v. Railroad (1904) 137 N. C. 104, 49 S. E. 96, (1906) 1 L. R. A. (N. S.) 604; Narragansett Elec. Light Co. v. Sabre (1929) 50 R. I. 288, 146 Atl. 777, (1930) 66 A. L. R. 1553; Notes (1930) 66 A. L. R. 1568; (1932) 81 *ibid.* 1071.

amend the charter contract.[42] No provision for the compensation of dissenters is necessary to the constitutionality of a consolidation statute, either of a public utility or of a private corporation, unless indeed the equitable remedies are superseded.[43] The reserved power to amend a corporate charter forms part of the charter contract. Under this power the majority may be authorized to make fundamental changes, such as amendments and sales of the entire assets. Every shareholder holds his shares subject to the exercise of all powers conferred upon the corporation and its managment.[44] The shareholder's right is a joint or associated interest in a common enterprise. That being so, a statute which provides for the sale of his interest at a fair market price as an alternative to taking the new securities offered in a merger should not require a stronger showing of public need and convenience to support it than a power of judicial sale as a method of partition among the co-owners of real or personal property. If it were not possible to make partition of joint and common interests such interests would often become worthless because of hopeless disagreements among the associates.

What is the purpose of provisions of statutes giving the option of compensation to a shareholder who objects to the merger or consolidation of his corporation with another? In the first place, compensation aims to give the dissenters a more simple and direct remedy, extending not only to cases of fraudulent changes but to those which are regarded by the dissenter as merely unfair or disadvantageous, in order that the minority may not be at the mercy of the majority. It offers the dissatisfied investor an assured market.[45] In the absence of statute for compulsory compensation the dissatisfied shareholder would have no assurance that he could find a purchaser who would buy his shares at a fair price.

In the second place, a great object of appraisal statutes may well be to expedite and make secure business transactions and to assist the

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42 See Dodd, *op. cit. supra* note 2, at 736; Note (1936) 105 A. L. R. 1452.

43 *In re* Interborough Consol. Corp. (S. D. N. Y. 1921) 277 Fed. 455; Market St. Ry. v. Hellman (1895) 109 Cal. 571, 42 Pac. 225; Mayfield v. Alton Ry. (1902) 198 Ill. 528, 65 N. E. 100; Jones v. St. Louis Structural Steel Co. (1932) 267 Ill. App. 576; Thomson v. Indiana Union Traction Co. (1915) 183 Ind. 690, 110 N. E. 121; *cf.* Levy, *Rights of Dissenting Shareholders to Appraisal and Payment* (1930) 15 CORN. L. Q. 420, 427.

44 Dickinson v. Consolidated Traction Co. (C. C. D. N. J. 1902) 114 Fed. 233, *aff'd*, (C. C. A. 3d, 1903) 119 Fed. 871, *cert. den.*, (1903) 191 U. S. 567.

45 Chicago Corp. v. Munds, *supra* note 3; Matter of Timmis (1910) 200 N. Y. 177, 181, 93 N. E. 522, 523. See New Jersey & Hudson River Ry. v. American Elec. Wks. (1911) 82 N. J. L. 391, 398, 81 Atl. 989, 992; Lattin, *op. cit. supra* note 27, at 237.

majority in carrying out legitimate changes without power in the dissenting shareholder to coerce the majority to buy him out on his own terms.[46] It is with this object in view that the California statute and that of Michigan as well were framed to provide that the remedy given to the minority should be exclusive of any legal or equitable remedy to attack the transaction on the ground of fraud or abuse of power which would tend to keep the whole transaction in uncertainty.

As the court recognized in the *Beechwood* case, the statutes of other states authorize merger and consolidation and provide for the appraisal of the shares of dissenters, without limiting the refusing shareholder's right to the payment of the fair market value of his shares. In the absence of such express limitation of his remedies the courts of these states have construed their statutes as making compensation merely an alternative or cumulative remedy and permitting dissenting shareholders to litigate the question of fraud in the proffered exchange of shares.[47]

It has been held that compensation statutes in the absence of illegality or fraud give the dissenting shareholder an adequate remedy, but the line between fraud and unfairness of consideration is a vague one and the remedy given should be the same whether the unfairness of the proposed exchange is more or less extreme. Are attacks to be allowed on the vagne ground of "constructive fraud" in the ratios of exchange? The question of motive or fraud is bound up with objections to the kind, amount, or value of the consideration to be received.[48] Even if the inadequacy is claimed to be so gross as to be "fraudulent" it is not unreasonable to limit the objecting shareholders to a choice between the securities offered and a right to the fair market value of their shares, which may be determined without creating unsettlement of the entire merger.

It may be asked: How does a suit for a rescission of a completed merger or consolidation by dissenting shareholders differ from a suit for the rescission of any ordinary contract or transfer of property by a

[46] STEVENS, *op. cit. supra* note 28, at 498; BALLANTINE and STERLING, CALIFORNIA CORPORATION LAWS (1938) 270-271.

[47] May v. Midwest Refin. Co. (S. D. Me. 1938) 25 Fed. Supp. 560, 563; Cole v. National Cash Credit Ass'n, *supra* note 4, at 55, 156 Atl. at 187; Homer v. Crown Cork & Seal Co. (1928) 155 Md. 66, 84, 141 Atl. 425, 434; 13 FLETCHER, *op. cit. supra* note 1, § 5893; Note (1933) 87 A. L. R. 597, 599, 603.

[48] United Milk Prod. Corp. v. Lovell (C. C. A. 6th, 1935) 75 F. (2d) 923, *cert. den.*, (1935) 295 U. S. 751; Allied Chem. & Dye Corp. v. Steel & Tube Co. (1923) 14 Del. Ch. 64, 68, 122 Atl. 142, 144, (1925) 14 Del. Ch. 368, 127 Atl. 414.

defrauded party? The answer is that the distinction is a practical one resting not in the culpability of the fraudulent parties but the practical hardships of attempting to undo and set aside a complex combination affecting numerous persons where many changes of position immediately take place on its consummation. If the shares of two or more corporations are transmuted into the shares of an entirely different corporation and these have in turn changed hands in an active market; if the properties of the several corporations have been united in a new or surviving corporation and the proceeds of the combined properties and businesses have been mingled, it is manifest that the tangled skein of events has become impossible of unravelling. The problem of readjusting the rights and interests of the corporations and of thousands of shareholders is so insurmountable as to make an attempt or a threat to do so almost fantastic if any other kind of relief can meet a dissenting shareholder's claim.[49] In the ordinary case of a contract or sale attacked as fraudulent, litigation over the particular transaction will not unsettle the status of several corporations and put them into a straight-jacket while the litigation is pending.

Modern decisions recognize more and more clearly that corporate powers must be exercised both by the management and by majority shareholders in good faith and without oppression of the minority.[50] It does not follow, however, that irresponsible and ruinous equitable suits to upset and rescind executed mergers and consolidations, and set aside all the transfers of property and shares of stock that have been made, begun without any preliminary executive or administrative inquiry, may not be superseded by other methods of protecting minorities. As is said by Circuit Judge Gray, in *Dickinson v. Consolidated Traction Co.*:[51]

"Courts of equity are reluctant to act in cases where their action would unsettle and disturb enormous interests, especially where most of them are attached to innocent third parties, and to which the interests of those invoking judicial action are overwhelmingly disproportioned."[52]

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49 "What counsel refers to as an 'eighty million dollar egg' of that character cannot be unscrambled and the expense and time involved in trying to do so would be so great as to amount to a denial of justice." May v. Midwest Refin. Co., *supra* note 47, at 565.

50 Topkis v. Delaware Hdw. Co. (Del. Ch. 1938) 2 A. (2d) 114, 119; S. E. C. Report VII, 566, 593; Berle, Jr., *op. cit. supra* note 4; Lattin, *Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders* (1932) 30 Mich. L. Rev. 645, 665.

51 *Supra* note 44, at 254.

52 *Ibid.* at 239.

It is, of course, well settled that a court of equity will not allow a dissenting shareholder to upset a charter amendment, consolidation, merger, or sale of the entire corporate assets if he is guilty of laches; that is, if he delays the assertion of his remedy until the rights of third persons have intervened or the defendants have expended money or incurred liabilities in reliance on complainant's apparent acquiescence or when it would be inequitable for any reason to grant such relief as an injunction or rescission.[53]

As a practical matter, the probable injury to innocent investors and business interests from granting a decree upsetting a disputed merger or consolidation which becomes the foundation of new rights and liabilities as soon as it is completed would seem a sufficient basis to establish by statute a general policy against suits for rescission. It is already the law that a comparatively slight delay followed by change of position will lead an equity court to grant compensation rather than any specific relief.[54]

Relief by way of rescission is usually prayed for, not for the honest purpose of obtaining such specific relief for plaintiff's own benefit or that of others, but because the mere seeking of it will threaten serious harm and hardship to all other persons concerned. It is generally held, however, that the evil motive of the complainant in bringing a shareholder's suit is no defense.[55] In view of the undue ease with which a small shareholder may sue in the role of a "representative," professing to be suing for the benefit of all, when the relief he seeks is claimed merely to exercise leverage for his own aggrandizement, the present unqualified legal right to make such attacks ought to be limited. A dissenting shareholder should be restricted to seeking relief to the extent of the injury done to him. How otherwise than by a limitation

[53] May v. Midwest Refin. Co., *supra* note 47; Rankin v. Interstate Equities Corp. (Del. Ch. 1935) 180 Atl. 541; Trounstine v. Remington Rand, Inc. (Del. Ch. 1937) 194 Atl. 95, 98; International & G. N. R. R. v. Bremond (1880) 53 Tex. 96, 119; see Note (1931) 70 A. L. R. 53.

[54] Jones v. Missouri-Edison Elec. Co., *supra* note 4 (relief in alternative); Paterson v. Shattuck Ariz. Copper Co. (1932) 186 Minn. 611, 632, 244 N. W. 281, 289, "Majority stockholders, though in the wrong, should not be subjected to every form or measure of penalty"; Johnson v. Railroad (1910) 227 Mo. 423, 127 S. W. 63; Windhurst v. Central Leather Co., *supra* note 25; see Note (1932) 30 MICH. L. REV. 1074, 1079.

[55] Johnson v. King-Richardson Co. (C. C. A. 1st, 1930) 36 F. (2d) 675; Runcie v. Corn Exchange Bank Trust Co. (N. Y. 1938) 6 N. Y. Supp. (2d) 616, 622; 13 FLETCHER, *op. cit. supra* note 1, §§ 5877, 5949; Simms, *An Application of the Doctrine that Consolidation Effects Dissolution* (1929) 15 VA. L. REV. 757, 758; Note (1934) 34 COL. L. REV. 1308, 1309.

of the remedy may we prevent an insignificant minority in one constituent from threatening to involve its corporation and all the other constituents in ruin for selfish purposes of its own?

The crucial point at issue in all these cases of dissenting shareholders is after all one of terms, of the value of the dissenting shares, perhaps of a small number of shares. It is not the object of the suit to inflict punishment for fraud. As the court said in *Homer v. Crown Cork & Seal Co.*:[56] "... if ... it appear that the fundamental issue ... is not fraud but a debatable controversy over value ... then the resolution of the difference of opinion of the majority and minority stockholders must be according to [the statute] ... notwithstanding the unity of ... control ... of the directors and stockholders of both the selling and the buying corporations."

It is much more practical to ascertain the fair market value of the shares of a particular constituent corporation than to ascertain the comparative value of the shares of several constituents. The court will be faced with a highly complicated problem of valuation if it has to appraise the assets of all the corporations concerned and also to estimate what each corporation has earned and may be expected to earn in the near future.[57] If the fair market value of the shares of the dissenter can be ascertained and given, that would seem to be adequate relief and would avoid injustice to the majority and also to other members of the minority.

The confining of individual remedies to compensation is needed not only for the protection of the majority but also for other minority shareholders. Suppose *A*, a minority shareholder, brings suit to annul the majority action on the ground of fraud. Suppose that *B*, *C*, and *D* prefer to seek the remedy of compensation. How can the law reasonably permit these inconsistent remedies to be pursued concurrently? It is necessary to favor one dissenter by suspending the effect of the demands of all the others for payment. Even a suit to test the sufficiency or regularity of the votes of the shareholders in authorizing a merger or consolidation will suspend proceedings for compensation of any other dissenting shareholders until final determination of such litigation.[58] Should some single member of a minority be able to hold

[56] *Supra* note 47, at 80, 141 Atl. at 432. See also Allied Chem. & Dye Corp. v. Steel & Tube Co., *supra* note 48.

[57] See 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 811, 816, 819; 13 FLETCHER, *op. cit. supra* note 1, § 5899; Notes (1935) 95 A.L.R. 922; (1934) 47 HARV. L. REV. 847, 851.

[58] CAL. CIV. CODE § 369 (18).

up all other proceedings although the rest of the minority desire cash compensation? Some method of settlement of internal strife should be devised which will permit business to go ahead without interruption.

The California statute furthermore reserves the right to the state, suing through its attorney general upon application of any interested party, to attack the merger or consolidation. Such remedy is guarded from abuse by the discretion which the attorney general would exercise to commence such proceeding only in case some good purpose could be served by it.[59] The filing of the merger or consolidation papers and other proceedings may be attacked for serious offenses against the statutory requirements or for fraudulent abuse or usurpation of corporate privileges or powers.[60] The attorney general is under a duty to bring the action whenever he has reason to believe that any franchise has been usurped, intruded into, or unlawfully held or exercised.

The equitable remedy of injunction is not foreclosed by subdivision (17) of section 369 prior to approval of the merger or consolidation agreement, because section 369 relates only to a merger or consolidation which has been approved by the requisite number of shareholders.[61]

CONSTRUCTION OF CALIFORNIA LIMITATIONS

Let us test out the California provisions and see what is their application in the most extreme and outrageous cases which can be imagined. Suppose a conspiracy of a group controlling *A* and *B* corporations by majority holdings to merge these corporations by a plan which will be grossly unfair and fraudulent to the shareholders of *A*. The controlling group furnishes false information to the shareholders of *A* and procures sufficient votes thereby to make up a two-thirds majority of all classes of shares to approve the agreement. What are the remedies (1) of the shareholders whose affirmative votes were procured by fraud, and (2) of the minority shareholders who are not defrauded but who object and dissent?

[59] See for an example of a similar limitation of remedy of members of fraternal insurance companies to attack mergers under a Kansas statute, Cavlovic v. Croatian Beneficiary Ass'n (1925) 117 Kan. 545, 232 Pac. 598.

[60] CAL. CIV. CODE § 404b; CAL. CODE CIV. PROC. § 803.

[61] Section 369 commences, "In the event that the requisite number of shareholders of a corporation approve its merger or consolidation with another corporation. . . ." and subdivision (17) of that section reads, "The rights and remedies of any shareholder at law or in equity to object to or litigate as to any *such* merger or consolidation. . . ." *i.e.*, any merger or consolidation which has been approved by the requisite number of shareholders. (Italics added.)

A distinction may be made between the remedies available to consenting shareholders for fraud in procuring the affirmative votes and the remedies of dissenting shareholders for fraud in the exercise of their power by the majority. As to consenting shareholders who have been misled into giving their vote of approval to the plan and discover the fraud only after the merger agreement has been approved by the requisite majority, there is a question whether the limitations of remedy in section 369 (17) should apply. The phrase in that paragraph limiting "The rights or remedies of *any shareholder* . . . to object to or litigate as to any such merger or consolidation"[62] might possibly be construed to extend only to shareholders "who shall not have approved such merger or consolidation at the meeting at which the same was approved," as the phrase is in section 369 (1), and who have the alternative remedy of compensation. This construction seems possible as section 369 deals primarily with the question of alternative remedies of dissenting shareholders who have not approved the agreement.

Stated literally, however, section 369 (17) says that no shareholder whatsoever of a California corporation involved in a merger or consolidation shall have any rights or remedies to litigate as to the merger or consolidation, except that if he is a dissenting shareholder he may be entitled to the fair market value of his shares from his corporation and except that he may sue to test whether the number of legal votes has been given. Unless the phrase "any shareholder" is given its natural meaning, a consenting shareholder might vote for the merger and then start his game of a strike suit on the alleged ground that he was defrauded, as he conspired to do when he cast his vote.

A consenter who has been defrauded should, of course, have an adequate remedy, but it would seem sufficient to leave him to his common law remedy for damages against the persons who have perpetrated the fraud without opening the door of section 369 (17) to nuisance litigation and to attacks on the entire merger or consolidation which the legislature has striven to forestall. By interpreting the worlds "to object to or litigate as to any such merger or consolidation" to exclude only suits to attack its validity and set it aside by rescission, there would be no bar against actions for damages for fraud. Likewise section 361 (5), which makes the filing of the merger or consolidation papers with the secretary of state "conclusive evidence of the performance of all conditions precedent," except as

[62] Italics added.

against the state, should only prevent attacks on the creation, and validity and existence of the merger or consolidation. It does not take away rights of action for fraud or conversion by consenting shareholders.[63]

Assume that a consenting shareholder still has a right of action to sue in equity on the ground that his affirmative vote was procured by fraudulent representations in the literature about the proposed merger prior to the shareholders' meeting, and that such a vote is not to be regarded as a "legal vote." Differences of opinion as to valuation of assets and methods of computing and accounting for depletion and depreciation are well known. It is a comparatively simple matter to make allegations which tend to give color of fraud. An interpretation which would permit shareholders, whether consenting or dissenting, a right to bring such suits would vest in them potent "nuisance value." Even assuming a right of action on the part of consenting shareholders to cancel votes procured by fraud, such annulment or cancellation would not upset the merger or consolidation if there were a sufficient two-thirds majority without such votes. Thus if the principal party to the alleged misrepresentation owned and voted more than the required number of shares, it wonld not be deceived and its votes would be legal and binding. The right of action of the defrauded shareholder, if any, would be that he was prevented from dissenting and from pursuing his remedy as a dissenting shareholder to recover the value of his shares. To set aside a merger a plaintiff would have to show that sufficient votes were procured by fraud to destroy the two-thirds majority of some class of shares and it is very doubtful whether he could set up fraud on other shareholders who were not complaining.

As to dissenting shareholders, what alternative remedies are open to them? What is the scope of the exception in section 369 (17) as to "actions to test whether the number of legal votes of shareholders required by statute to authorize or approve the proposed action of the corporation has been given"? What is included in "legal votes"?

In using the phrase "legal 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. No such vague topics of litigation were intended. A "legal vote" is simply a vote cast by a person who is legally entitled to cast it.

63 Mills v. Tiffany's, Inc. (1938) 123 Conn. 631, 198 Atl. 185; Bown v. Ramsdell (1929) 227 App. Div. 224, 237 N. Y. Supp. 573; Lattin, *op. cit. supra* note 27, at 234-236.

There are various provisions in the California General Corporation Law which might affect the legality of a vote. For example, section 320a of the Civil Code provides that, subject to the provisions of sections 320b and 320c, only persons in whose names voting shares stand on the stock records of the corporation on the day three days prior to any meeting of shareholders, or if some other day be fixed for the determination of shareholders of record, then on such other day, shall be entitled to vote at such meeting. Section 320b provides the legal requirements for voting by fiduciaries, incompetents, minors, and corporations, and section 320c provides the legal requirements with respect to voting shares standing in the names of two or more persons. Section 321a sets forth the statutory provisions regarding voting trusts. Section 321 contains the statutory regulations regarding proxies. Section 318 authorizes the fixing of a record date for the purpose of determining shareholders of record entitled to vote or to receive distributions. If in soliciting proxies the management sends out a copy or summary of one merger agreement and then acting under a proxy which refers to that agreement votes the shareholders' stock without authority in favor of an entirely different merger, such a vote would not be a binding or legal vote.

A vote cast by a shareholder who is legally entitled to cast the same in accordance with the pertinent provisions of the articles of incorporation and by-laws of the corporation and the statutory provisions governing the right to vote is a "legal vote" regardless of the reasons or motives which the shareholder may have entertained in casting his vote and regardless of any influence or representation which may have induced him so to cast his vote. If any other interpretation were to be given to the phrase "legal vote" the door would be left open to the "strike-suiter" to allege that fraud had motivated or induced the casting of the votes necessary to make up the required two-thirds of one or more of the different classes of shares. Thus, the intent to prevent attacks upon the creation or existence of a merger or consolidation, except on the ground of formal matters of authorization comparatively easy of investigation, would be defeated.

Suppose that the notice of the meeting did not state the time, place, and purpose thereof or was not given twenty days prior to the date thereof or was not accompained by "a statement of the general terms of the proposed agreement," all as required by section 361 (3) Civil Code. Might a shareholder raise these questions by a suit in equity to enjoin or set aside a merger?

It may well be that prior to the filing of the papers with the secretary of state an action might be brought to test whether the number of legal votes of shareholders had been given on the ground that a "legal vote" could only be given by a shareholder or by majority shareholders at a meeting which had been legally called and held. After the papers had been filed, however, such a suit would be confronted with the provision of section 361 (5) that the filing of papers shall be conclusive evidence of the performance of all conditions precedent to such consolidation or merger. This provision seems broad enough to forbid not only collateral attack by third parties, but also a direct attack on the votes by any shareholder concerned except as he might persuade the attorney general to bring a *quo warranto* proceeding for the purpose.

Suppose that the agreement of merger was never approved by a majority of the board of directors of *A*, but only by one or two directors, or that it was never signed and acknowledged by the officers as provided in section 361, subdivisions (1) and (2) of the Civil Code. Suppose that there was a deliberate forgery and falsification of the officers' certificates as to the approval of the merger agreement. Could a shareholder in *A* corporation make no attack upon a merger after the false papers had been filed? It would seem not, even in this extreme case. But upon a proper showing to the attorney general, that official could no doubt be persuaded that it was his duty to institute an action in the name of the state to set aside the fraudulent merger or consolidation upon the complaint of the objecting shareholder.[64] The criminal penalties which could be imposed upon corporate officers guilty of such falsification would also serve as a deterrent to such misconduct.[65]

Suppose all of the formal statutory requirements are complied with but the statement of the terms of the agreement and other literature disseminated to the shareholders contains misrepresentations as to facts bearing on the fairness of the terms of the merger agreement or omits to disclose pertinent facts. Would a question as to the "legality" of the vote be presented here? It is believed, as indicated above, that a shareholder's suit based on a complaint alleging misrepresentation of material facts in the notices and literature disseminated for the purpose of procuring the votes would not come within the statutory

[64] Cal. Civ. Code § 404b; Cal. Code Civ. Proc. § 803.

[65] See Cal. Pen. Code §§ 558, 563, 564. It may seem extraordinary that the merger agreement could not be attacked when those who brought it about have been imprisoned for forgery and other crimes.

exception as to "legal votes." It could not be claimed by dissenting shareholders, since they did not vote for the agreement, that they had been defrauded, and it is doubtful on general principles whether they or consenting shareholders could complain of fraud on other shareholders who do not sue.

Suppose purported merger proceedings are used as a device primarily to make an adjustment in the stock structure and eliminate arrears of unpaid cumulative dividends on preferred shares, as where a parent corporation absorbs a single wholly owned subsidiary without the issue of any new shares and continues to function under its old name and charter with certain changes in the rights of its preferred shareholders? May such preferred shareholders attack the so-called merger on the ground that it is merely a subterfuge and a form to amend the articles of incorporation under the guise of a merger? There is nothing in the California statute which would prevent a court from treating a pretended merger as being in reality and substance only an amendment of the articles as the Delaware court has recently done.[66] The provisions as to dissenting shareholders and limitations of remedy only apply to actual mergers and consolidations in California, not to sales of assets or amendments of the articles. As is well said in a note,[67] "Recapitalization may be either the sole purpose of a formal merger or it may be merely incidental to a genuine merger. In the former case, if litigation ensues, consistency with the amendment cases would require a court to enjoin the merger or the distribution of new securities without regard to the fairness of the exchange. However, where there is a genuine merger, there must be some distribution of new securities, and the court's only purpose is to see that the distribution is fair, *i.e.*, that proper recognition is given to the accumulations."

We may summarize the remedies available to shareholders in cases of merger or consolidation as follows:

1. Prior to the filing of the merger or consolidation agreement, and certificates as to its approval, with the secretary of state:

(a) The right to sue to enjoin the continuation of the merger or consolidation proceeding for failure to comply with any one or more of the requirements of section 361, or for threatened fraud, prior to approval by the shareholders.

(b) The right to institute an action to test whether the number of legal votes of shareholders (meaning votes cast by persons legally

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66 See Havender v. Federal United Corp., *supra* note 37; S. E. C. Report VII, 329; Note (1939) 27 Geo. L. J. 371.

67 (1937) 4 U. of Chi. L. Rev. 645, 650; *ibid.* at 648.

entitled to vote regardless of the motives or influences which may have induced the casting of such votes) required by statute to authorize or approve the merger or consolidation have been given at a meeting duly called, and ancillary to such an action, the right to enjoin the consummation of the merger or consolidation during the pendency of the action.[68]

2. Subsequent to the filing of the merger or consolidation agreement, and certificates as to its approval, with the secretary of state:

(a) The right to request the attorney general to bring an action in the name of the state on the complaint of the shareholder to set aside the merger or consolidation for lack of authorization because of failure to comply with any one or more of the requirements of section 361.

(b) The right to request the attorney general to bring an action in the name of the state on the complaint of such shareholder to set aside the merger or consolidation on the ground that the number of legal votes of shareholders (meaning votes cast by persons legally entitled to vote regardless of the motives or influences which may have induced the casting of such votes), required by statute to authorize or approve the merger or consolidation, has not been given.

(c) The right to request the attorney general to bring an action to dissolve any corporation which fraudulently or unlawfully holds or exercises any franchise or any corporate privileges or powers.

(d) The right of the dissenting shareholder to be paid the fair market value of his shares, in accordance with Civil Code section 369.

(e) The common law right of the consenting shareholder to sue for damages for fraudulent procurement of his vote or for conversion of his shares.

CONCLUDING SUGGESTIONS

If the present legal and equitable remedies are unsatisfactory as a curb on the powers of the dominant group, what possible safeguards may be devised to secure better protection of all classes of shareholders and promote the fairness of voluntary reorganizations? A number of suggestions have been made which deserve careful study as to their expediency and convenience.

[68] *Quaere*: Even if a suit to test the sufficiency or regularity of the votes of the shareholders were commenced prior to the filing of the papers specified in subdivision (5), would the act of the secretary of state be conclusive as against a shareholder bringing such action to test the votes, or could section 369 (17) be construed with section 361 (5) as making an implied exception to the general language of section 361 (5) in favor of such suit? Must the right to continue such suit be protected by a preliminary injunction restraining the secretary of state from filing the papers?

1. A somewhat ambitious proposal is to establish some form of administrative supervision of reorganizations and of plans for modifying contract rights or forcing an exchange of securities, which would put the burden of justification upon the controlling group to show the fairness of the proposed transaction.[69] A supervisory power over corporate changes may be more effectively exercised by an administrative commission than by the courts.[70] The necessity of obtaining some kind of permit or approval or at least an advisory report from an independent authority will doubtless tend to compel the proponents of drastic changes to evaluate more fairly the relative interests of different classes of shareholders.

Would such supervision impose an unreasonable burden? Many lawyers, bankers, and business men believe that we have too much administrative regulation of what they regard as private business transactions between individuals.[71] Some progress is, however, being made in the direction of administrative supervision.

In 1935 the California Corporate Securities Act was amended to vest in the commissioner of corporations the authority to approve the terms and conditions of the issuance and exchange of securities after a hearing upon the fairness of such terms and conditions, if such hearing be requested in an application for a permit to issue securities in exchange for outstanding securities, or partly in such exchange and partly for cash.[72] The applicant must pay the estimated expenses of such a hearing. This is intended to meet the conditions of the Federal Securities Act of 1933, section 3a (10),[73] giving exemption to securities so approved. In the absence of a request for an affirmative finding of fairness by the commissioner it is only required that the commissioner find that the securities to be issued and the methods to be used in issuing and disposing of them are not so unfair, unjust, or inequi-

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69 See Notes (1937) 4 U. OF CHI. L. REV. 645, 656-657; (1935) 44 YALE L. J. 1025, 1049 (which sets out a plan of procedure for confirmation of recapitalization plans by a court); (1935) 45 *ibid.* 105, 119; (1937) 45 *ibid.* 985. See BALLANTINE and LATTIN, *op. cit. supra* note 4, at 771.

70 Note (1939) 33 ILL. L. REV. 914, 921.

71 Berlack, *op. cit. supra* note 23, at 607-611; Swaine, *"Democratization" of Corporate Reorganizations* (1938) 38 COL. L. REV. 256, 262.

72 Cal. Stats. 1935, p. 835, § 4; Rules and Regulations of the Division of Corporations (1936) c. 36; Notes (1935) 23 CALIF. L. REV. 348; (1935) 24 *ibid.* 107. See BALLANTINE and STERLING, *op. cit. supra* note 46, at 385; Note (1936) 45 YALE L. J. 1050, 1072.

73 48 STAT. (1933) 74, 15 U. S. C. (1934) § 77a *et seq.*, as amended 48 STAT. (1934) 905, 906, 15 U. S. C. (1934) § 77c (10).

table as to work a fraud upon the purchaser. The more extensive hearing and more positive finding as to fairness of the terms and conditions of the issuance and exchange are necessary to satisfy the federal exemption provision. The commissioner of corporations also requires a permit for an amendment changing the preferences of outstanding preferred shares.[74]

Under the Public Utility Holding Company Act of 1935[75] the Securities and Exchange Commission in practical effect passes upon the fairness of both judicial and voluntary plans of reorganization of any registered holding company or any subsidiary thereof.[76] The Commission after a hearing, must formulate a report on every voluntary reorganization plan. Such a plan ordinarily involves either an issuance of new securities or an alteration of preferences of outstanding securities. Under sections 6 and 7 of the Act the Commission has power to permit or refuse to permit the issuance of new securities or the alteration of the rights of security holders. As pointed out by Mr. Abe Fortas, Assistant Director of the Public Utilities Division, in an able address on "Corporate Reorganizations and the Holding Company Act," July 14, 1938: "Consequently, the Commission's power with respect to voluntary reorganization plans is double barreled.... In passing upon the issuance of new securities pursuant to a voluntary reorganization plan, it would consider the fairness of that plan.... In effect, it has the power to disapprove a voluntary plan on the grounds that it is unfair. And it also has the power ... to regulate solicitation methods," that is of proxies and consents to any reorganization plan of a registered holding company or a subsidiary thereof. Mr. Fortas emphasizes the point that customarily the management and the common shareholders have control and dictate the terms of plans of voluntary reorganizations to the great prejudice of the contract rights of preferred shareholders. He advocates administrative supervision.

2. An alternative proposal is the authorization of some governmental agency, perhaps a commission, possibly the attorney general or a division of the state justice department, to represent shareholders, with full powers of investigation and the duty of bringing actions to protect the rights of investors as the need appears.[77] The remedy thus

74 CALIFORNIA CORPORATE SECURITIES ACT (1917) § 26; BALLANTINE and STERLING, *op. cit. supra* note 46, at 386.

75 49 STAT. (1935) 803, 15 U. S. C. SUPP. IV (1937) § 79.

76 Meck and Cary, *op. cit. supra* note 13, at 247; Note (1939) 33 ILL. L. REV. 914, 943-944.

77 Berlack, *op. cit. supra* note 23, at 611-614.

provided should be made exclusive of individual suits. This would relieve the shareholders of the burden of investigation and the corporations and their managements would be protected against strike litigation. The provision of the New York General Corporation Law granting to the attorney general the power to bring actions for relief obtainable in certain cases in a stockholder's suit confers such authority, but thus far apparently it has not been utilized.[78]

3. In the absence of official representation, a shareholders' protective association, like the British Shareholders' Protective Association, might be formed to represent investors. It should be a quasi-public corporation on a service or cooperative rather than on a profit-making basis, with some sort of governmental approval or backing, the costs to be paid by the investors as a group.[79] This would provide some agency to think and act for lethargic and helpless shareholders.

4. A protective measure, already adopted to some extent, is to require statements of full information when soliciting proxies or assents for amendments and plans of voluntary reorganization. The Securities and Exchange Commission has made rules[80] regulating the solicitation of proxies under the Securities and Exchange Act of 1934.[81] A "proxy statement" is to be furnished in connection with the solicitation of proxies, consents or authorizations in respect of any security registered on any national securities exchange. Item 11 of Schedule 14-A of the report[82] sets forth the information required in respect of any plan of merger or consolidation, or transfer of all or a substantial part of the assets of the issuer in exchange for securities of another issuer, including the material features of the plan or a copy of the document in which it is set forth. Financial statements of the issuer and of each "person" which is to be merged into the issuer or into which the issuer is to be merged or consolidated, or which is the issuer of securities to be acquired, are called for. Information is also to be given as to dividends in arrears or any default in principal or interest of any securities of any such person; also the high and low sales prices

78 N. Y. GENERAL CORPORATION LAW (1909) §§ 60, 61, 134.

79 Douglas, *Directors Who do not Direct* (1934) 47 HARV. L. REV. 1329-1334.

80 General Rules and Regulations under the S. E. C. Act of 1934 (April 15, 1939) 1401. See excellent comments (1939) 33 ILL. L. REV. 914, 922, 932, 934, 941; (1939) 13 ST. JOHN'S L. REV. 297. See also Fourth Annual Report of the Securities and Exchange Commission (1938) 69-73. See Dean, *Non-compliance with Proxy Regulations: Effect on Ability of Corporation to Hold Valid Meeting* (1939) 24 CORN. L. Q. 483.

81 48 STAT. (1934) 881, 15 U.S.C. (1934) § 78a.

82 *Supra* note 80, at 1406, 1411.

of any securities of any such person for each quarterly period within two years. Item 2[83] requires a summary or statement of applicable provisions of statutory laws relating to rights of appraisal or similar rights of dissenters with respect to any matter to be acted upon pursuant to the proxy.

In 1937 section 362a of the Civil Code of California was amended[84] to include a provision requiring that in the solicitation of proxies for the purpose of voting upon any amendment of the articles which would change the rights of outstanding shares in certain respects, the corporation shall mail a concise summary of the proposed amendments and the changes in shareholders' rights proposed to be effected thereby.[85] A similar requirement might well be extended to mergers and consolidations, sales of entire assets and other fundamental changes in so far as they are not covered by the federal rules.

An interesting legislative problem is whether the remedy provided for dissenting shareholders under section 369 with its limitations should be extended to shareholders who dissent from the sale of the entire assets of a corporation,[86] or even to amendments changing preferential rights. Under the California General Corporation Law there is no compensation provision respecting the sale of entire assets or any change other than consolidation or merger, as under the Delaware law. If this provision were extended too far, it may be that corporations would be driven to incorporate under the Delaware law. In New York, Minnesota, and Ohio, however, more extensive provision is made for the compensation of dissenting shareholders. Under the New York Stock Corporation Law,[87] for example, provision is made in cases of adoption of an employee stock purchase plan, the sale of entire assets and amendments altering preferential rights of outstanding shares as well as merger and consolidation.[88] In matters such as amendments changing the authorized lines of business of the corporation or extending the period of its existence, it would seem that there is no such danger of abuse that action taken by majority shareholders

[83] *Ibid.* at 1406.

[84] Cal. Stats. 1937, p. 1894.

[85] BALLANTINE and STERLING, *op. cit. supra* note 46, at 253.

[86] CAL. CIV. CODE § 343. See S. E. C. Report VII, 592-597, as to types of voluntary corporate readjustments included in various appraisal statutes.

[87] N. Y. STOCK CORPORATION LAW (1923) §§ 14, 20, 21, 38-12, 85-7, 87, 91-7.

[88] See also ILL. BUSINESS CORPORATION ACT (1933) §§ 70, 73; OHIO GENERAL CORPORATION ACT (1927) § 72; MINN. BUSINESS CORPORATION ACT (1933) §§ 39, 43; UNIFORM BUSINESS CORPORATION ACT §§ 42, 48, 9 Unif. Laws Ann. 94, 98.

should not be binding on all. An amendment changing a profit corporation into one not for profit, or even into one partially charitable, would be another matter. As to sales of the entire assets, particularly when made for shares of stock, it seems inconsistent not to make provision for compensation of dissenting shareholders. This is particularly the case when it is recognized that a sale of assets for shares is commonly used as a method of merger or consolidation.[89]

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[89] Hills, *Consolidation of Corporations by Sale of Assets and Distribution of Shares* (1931) 19 CALIF. L. REV. 349, 361, n. 16; Notes (1932) 79 A. L. R. 624, 645; (1932) 20 CALIF. L. REV. 421.