Court Of Appeal Rejects Omnicare In Favor Of Jewel Companies

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Yesterday, the California Court of Appeal issued a brief, yet interesting, opinion that addressed several questions of California corporate law, *Monty v. Leis*, Cal. Ct. of Appeal (Div. 6) 2d Civil No. B225646 (March 30, 2011).

The Facts

The case initially involved a suit by two shareholders of a bank to stop an infusion of additional capital required by the bank's regulators. By the time the case made its way to the Court of Appeal, the transaction had closed and the plaintiffs were seeking rescission.

In 2009, the bank obtained shareholder approval of an amendment to its articles to increase its authorized number of shares from 250 million to 500 million. Thereafter, the bank entered into an investment agreement with Ford Financial Fund, LP ("Ford"). The agreement required Ford to provide $500 million in new capital to the bank. Upon closing the transaction, Ford would receive 225 million shares of common stock and 455,000 shares of convertible preferred stock. According to the court, the issuance of both the common and preferred stock were well within the 500 million shares of common and the one million shares of preferred authorized by the bank's articles at the time the investment agreement was made. The 455,000 shares of preferred stock issued to Ford would convert to 2.275 billion shares of common stock. The issuance of 2.275 billion shares of common stock required an amendment of the articles of incorporation. The bank planned to issue the 225 million shares of common stock to Ford on the closing date. The shareholders had previously approved an amendment to the articles authorizing those shares. The 225 million shares would give Ford a majority of bank's stock and enough voting power to approve an amendment to the articles. Thus, after obtaining the 225 million shares, Ford alone would vote immediately to amend the articles to authorize the issuance of 2.275 billion shares of common stock required by the investment agreement. As a result, the transaction could be completed without the vote of any shareholders other than Ford.

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Section 405(a)

The plaintiff shareholders argued that the bank's plan violated Section 405(a) of the Corporations Code because the investment agreement required the bank to issue more shares than were authorized when it was entered into. Section 405(a) provides:

> *If at the time of granting option or conversion rights or at any later time the corporation is not authorized by its articles to issue all the shares required for the satisfaction of the rights, if and when exercised, the additional number of shares required to be issued upon the exercise of such option or conversion rights shall be authorized by an amendment to the articles.*

The Court of Appeal focused on the phrase "or at any later time" and concluded that Section 405(a) "clearly does not require that the articles be amended at the time of the granting of the option or conversion rights".

Fiduciary Out

The plaintiffs also argued that the bank's board breached its fiduciary duty by failing to include a provision allowing bank to back out of the deal if a better offer is made. The plaintiffs pointed to the Delaware Supreme Court case, *Omnicare, Inc. v. NCS Healthcare*, *Inc.*, 818 A.2d 914 (Del. 2003), for the proposition that an investment agreement must contain such a way out. The Court of Appeal, however, looked to *Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc.,* 741 F.2d 1555 (9th Cir. 1984), a case decided under California law. In *Jewel*, the court held that a board of directors may lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers. Thus, the Court of Appeal concluded that the board had no obligation to include a "fiduciary out".

Section 1001

Finally, the Court of Appeal rejected the plaintiffs' argument that the investment agreement required shareholder approval as a sale of all or substantially all of a corporations assets pursuant to Section 1001.

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