California's 50/90 Rule – When Being In Control May Mean That You're Not

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Many out-of-state practitioners are surprised to learn that California has special statutory provisions governing a merger when a constituent corporation (Section 161) or its parent (Section 175) owns, directly or indirectly, more than 50% of the voting power (Section 194.5) of the other constituent corporation prior to the merger. This is the so-called "50/90 Rule". It can be found in the last sentence of Section 1101. Under the 50/90 Rule, the nonredeemable common shares or nonredeemable common equity of the acquired constituent corporation may be converted only into nonredeemable common shares of the surviving party or parent party.

The 50/90 rule does not apply:

- In the case of a short-form merger (Section 187);[1]
- If the Commissioner of Corporations, Commissioner of Financial Institutions, the Public Utilities Commission approves the terms and conditions of the transaction and the fairness of those terms and conditions pursuant to specified provisions of the Corporations, Financial, Insurance or Public Utilities Code, as the case may be; or
- If all of the shareholders of the class consent

The 50/90 Rule also won't apply to the disposition of fractional shares in accordance with Section 407 (n.b. – the limitations on cash outs of fractional shares in that statute). The purpose of the rule is to prevent squeeze outs of minority shareholders. Notably, the California legislature extends (via Section 2115) the protections of the 50/90 Rule to pseudo-foreign corporations.

There's a lot more that can be said about the 50/90 Rule. Sam Dibble provides additional explanation, historical background and some suggestions in this article.

Section 1101 is being made an issue in litigation arising out of the recent acquisition of Applied Signal Technology, Inc. by Raytheon Company. In January, a shareholder filed a putative class action complaint alleging, among other things, violation of the 50/90 Rule. Although Santa Clara Superior Court

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Judge James P. Kleinberg denied the plaintiff's *ex parte* application and the acquisition has been completed, the plaintiff has recently filed an amended complaint.

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[1] In 1990, Section 1110 governing short-form mergers was amended to include "downstream" mergers of a parent into a subsidiary. However, Section 1101 has not been amended to reflect this change. As a result, Section 1101 has an exception for short-form mergers and (redundantly) megers "mergers of a corporation into its subsidiary in which it owns at least 90 percent of the outstanding shares of each class".

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