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QUALIFICATION OF SECURITIES IN CALIFORNIA: HOSTILE TERRITORY FOR FOREIGN ISSUERS

by

JAMES K. ROOSA*

INTRODUCTION

The California Department of Corporations' current policies regarding securities regulation reflect an extreme bias against takeover defensive measures contained in the articles and bylaws of foreign issuers offering their securities in California. These policies are objectionable on two major grounds: First, they are entirely unwritten, and thus create significant potential pitfalls for the unwary, foreign issuer whose articles or bylaws contain these takeover defensive measures. Second, the effect of eliminating these protective measures is to place the foreign issuer's minority shareholders at a severe disadvantage in the event of a hostile takeover.

The purpose of this article is to outline these policies and to discuss the threat which compliance poses to the issuer's shareholders as well as the corporation law of the issuer's home state. Although much of the discussion is couched in terms of Ohio law and Ohio issuers, it applies equally to other jurisdictions whose corporation laws are similar to Ohio's.

Defensive Measures Generally

In addition to Ohio's "control share" acquisition statute (Ohio General Corporation Law § 1701.831) and other statutory provisions validating the discriminatory (or "flip-in") aspects of shareholder rights plans, commonly known as "poison pills," many Ohio corporations elect to further protect their shareholders from the potential abuses of a hostile takeover bid through adoption of a variety of defensive measures, many of which are included in their articles of incorporation or code of regulations. Ohio General Corporation Law §§ 1701.04 and 1701.11 give an Ohio corporation much leeway in drafting its articles and regulations, so long as they are "consistent with law." Unlike some states (e.g., Delaware, New York, and Wisconsin), Ohio does not presently have a business combination statute, although one has been introduced in the Ohio legislature and is expected to be enacted in the near future.

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Under Ohio General Corporation Law § 1701.59(C)(1)(a), a director is given the responsibility of protecting the corporation's shareholders in the event of a change in control. To this end, he is entitled to consider factors other than the amount of money offered by a corporate raider (§ 1701.59(E)). For instance, does the raider intend to "milk" the target or sell off its divisions after gaining control? It is this fiduciary responsibility to the corporation's shareholders from the potential abuses of a hostile takeover that drives many of the protective measures discussed in this article.

Notwithstanding criticism as management entrenchment devices, defensive measures in some form have been adopted by most publicly held corporations in Ohio, as well as across the nation. According to one study, 403 of the 424 publicly traded companies in the Fortune 500 have adopted at least one defensive measure. (J. Heard & H. Sherman, *Conflicts of Interest in the Proxy Voting Process* 25 (Investor Responsibility Research Center 1987)).

The Problem

ABC, Corp., an Ohio Corporation ("ABC"), wishes to sell its Common Shares in various states, including California. ABC's blue sky analysis indicates that no exemption from registration is available in California for this particular offering. Pursuant to the California securities statute and blue sky regulations, ABC submits the required state registration materials to the California Department of Corporations ("Department").

Shortly thereafter, ABC receives a letter requiring compliance with the following conditions in order to qualify its shares for sale in California:

- 1) Change ABC's code of regulations to provide that special meetings can be called by 10% of the outstanding Common Shares (as opposed to the current provisions which require 25% of the outstanding Common Shares);
- 2) Add a regulation providing for removal of directors at any time with or without cause by 2/3 vote of all outstanding Common Shares (as opposed to the current provisions which allow removal only for cause);
- 3) Eliminate the current fair price provisions in ABC's articles of incorporation and reduce the accompanying supermajority provision requiring an 80% shareholder vote for approval of certain transactions with "interested parties" to 66 and 2/3%; and

- 4) Change the current regulation providing for mandatory reimbursement of litigation expenses for outside directors to one which is permissive in nature.

The "Fairness Standard" and Foreign Corporations

The purported authority of the Department to impose these conditions on foreign issuers is vague at best (since the Department does not cite any authority when imposing these conditions), but presumably is derived from § 25240 of the California Corporate Securities Law of 1968, which provides, in pertinent part, that "[t]he commissioner may . . . den[y] effectiveness to . . . any qualification of securities . . . if he finds (1) that the order is in the public interest and (2) that the proposed plan of business of the issuer or the proposed issuance or sale of securities is not *fair, just, or equitable*, or that the issuer does not intend to transact its business fairly and honestly, or that the securities proposed to be issued or the method to be used in issuing them will tend to work a fraud upon the purchaser thereof." (emphasis added).

Significantly, California corporation law contemplates the presence of foreign corporations. Under California General Corporation Law § 2115, the corporation law of a foreign corporation (i.e. incorporated in a state other than California) which establishes certain "minimum contacts" with the State (more than 50% of the issuer's outstanding voting shares held of record by California residents and more than 50% of its business conducted in California) is displaced by California corporation law. This, in itself is a radical approach to treatment of foreign corporations, and creates the potential for difficult choice of law problems in the event of litigation against the foreign corporation in its home jurisdiction. The provisions of California corporation law which are specifically applicable to a § 2115 Foreign Corporation include those imposed on foreign issuers of securities as discussed above. Curiously, the 10% special meeting call requirement for issuers of securities is *not* applicable to foreign corporations meeting the 50% "minimum contacts" test.

In the case of a foreign corporation doing business in California, § 2115 provides notice that by maintaining a significant presence in the state, the corporation laws of the foreign corporation's home state will be displaced by those of California. The problem, however, is that in the case of foreign issuers of securities with perhaps a *de minimis* business presence in the state, no analogous notice provision exists.

The Ohio Approach

Resistance on the part of Ohio issuers to the conditions imposed on corporations like ABC in our example is well-founded since the challenged provisions are clearly legal under Ohio law and the potential impact of compliance on the issuer's ability to protect its shareholders against abusive tactics by raiders is significant.

1. Ten Percent Special Meeting Call

Ohio General Corporation Law § 1701.40(A)(3) provides that meetings of shareholders may be called by "persons who hold 25% of all shares outstanding and entitled to vote thereat," unless otherwise provided in the articles or regulations. In light of the presumption of the Ohio Legislature that 25% is an appropriate proportion of share ownership to call a special meeting, most Ohio corporations employ this percentage (at a minimum). The 25% requirement is intended, in part, to minimize the possibility of the company having to incur the expense and diversion of management attention required in order to hold a special meeting unless the raider has a reasonable degree of support and likelihood of success.

2. Removal of Directors

Another common defensive measure employed by Ohio corporations is that of the "staggered" board of directors. The staggered board structure has two interrelated aspects: First, directors can only be removed for cause (typically defined in the regulations as gross negligence or willful misconduct) which is permitted by Ohio General Corporation Law § 1701.58(C). Second, the term in office of a portion of the board expires each year so that in the event of a partial takeover bid, a portion of the directors in office prior to a takeover will remain in office long enough to protect the interests of minority shareholders. In addition, this structure delays a total takeover since it typically requires several years to replace all board members. The effect of allowing removal of directors without cause is to render the staggered board useless as a defensive measure and to leave minority shareholders without board representation in the event of a takeover.

3. Supermajority and Fair Price Provisions

Under Ohio General Corporation Law § 1701.52, an Ohio corporation may provide in its regulations that certain actions require a high vote or "supermajority" of shareholders for approval. Supermajority voting provisions typically require a raider to acquire 80-95% of a corporation's voting shares before he can override Fair Price provisions in a corporation's

articles, which would otherwise require him to pay all shareholders in a "two-step" acquisition the same "fair price" for their shares. Without the benefit of a supermajority provision, those shareholders not coerced into selling out to the raider during the initial tender offer would be required to take whatever was offered to them for their shares in the second step merger (which would inevitably be less and perhaps different consideration than was received by shareholders who tendered their shares in the initial tender offer).

4. Indemnification of Outside Directors

Ohio General Corporation Law § 1701.13(E)(5)(a) provides that, except in limited circumstances, expenses incurred by a director in defending a lawsuit resulting from his or her position as a director "*shall* be paid by the Corporation as they are incurred, in advance of the final disposition of the action, suit, or proceeding . . ." (emphasis added). The director to whom expenses are advanced must undertake to repay such amounts if it is eventually proven that his or her actions were improper.

The effect of compliance with the California requirement that indemnification be made permissive, in the case of small issuers on whose board of directors a seat is not sought after as keenly as a seat on the board of a Fortune 500 Company, is to discourage qualified outside individuals from becoming directors. The rationale behind California's requirement that Ohio issuers change their regulations to make such indemnification permissive is vague, at best. In any event, the repayment provisions contained in 1701.13(E)(5)(a)(i) eliminate most (if not all) risk of abuse.

Options For Issuers

Ohio issuers confronted with the California requirements have several (albeit limited) options:

1) Negotiation

This option typically entails engagement of local counsel and therefore may prove costly. Even then, experience has proven that the California Commissioner of Securities is inflexible regarding these unwritten policies.

2) Administrative Hearing

A would-be issuer may challenge an order of the Commissioner denying or postponing effectiveness of a qualification (California Securities Law § 205143). However, where the issuer is cost-sensitive and under time

pressure, this alternative may not be viable.

3) Compliance

Aside from the effect of “undoing” an issuer’s existing defensive mechanisms, implementation of these changes will usually involve obtaining shareholder approval. Depending on the time of year, it may also require a special meeting and the accompanying expense.

4) Abandonment of offering in the state of California

CONCLUSION

California’s current unwritten policies regarding qualification of foreign securities highlight the importance of finding an exemption from registration whenever possible, since compliance may pose a direct threat to the integrity of the issuer’s corporation law as well as the rights of its shareholders in the event of a hostile takeover. These policies are particularly frustrating since in many cases they involve substantive revision or “undoing” of charter provisions that have been carefully crafted and implemented by the issuer to deal with specific abuses associated with hostile takeovers. Curiously, the Department’s review of a foreign issuer’s defense measures excludes scrutiny of poison pills. In the case of an issuer offering its shares in several states, the requirement that it amend its charter documents in order to appease one state is extremely unfair and is a classic argument in favor of uniform securities regulation among the states.