Key California M&A Considerations for Life Sciences Businesses: Part 1

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Whether you plan on "doing business" in California, selling a business in California, acquiring a business that is a California entity or merging with a business that is in California, the process may appear straightforward. However, business owners, including those in the life sciences industry, commonly overlook multiple issues and considerations related to California.

This is the first article in a two-part series addressing a few key items that life science business owners should consider when dealing with a merger or acquisition in California. Part 1 addresses approval mechanics, corporate governance requirements, minority protections, dissenters' rights, California's permit and fairness hearing process and the quasi-California corporation "long-arm" regime. Part 2 will address dispute resolution considerations, the enforceability of restrictive covenants and tax issues that frequently affect deal structure and negotiation.

- **Separate Class-Vote Requirement for Shareholder Approvals**. In California, a majority vote of all the outstanding shares taken as a whole is not sufficient for approval of a merger; a majority of each class must approve. Moreover, the Cal. Corp. Code does not contain any provision allowing California corporations to waive the separate class-vote requirement. Consequently, any shareholder or group of shareholders holding the majority of one class of shares can potentially block a proposed merger transaction, notwithstanding the transaction's approval by the corporation's board of directors and other shareholders holding the majority of the corporation's outstanding shares on a combined basis.

- **Number of Directors for Board Approvals**. The number of directors must be either a specified number or a range identifying an acceptable minimum and maximum number of directors. Subject to certain exceptions (outlined below), the minimum number in a range cannot be less than three and the maximum number cannot exceed the minimum by more than two times the minimum minus one (e.g., not less than three nor more than five). There may be one director only if there is one shareholder. Additionally, there may be two directors only if there are no more than two shareholders. Consequently, if an entity that is formed in California is not in compliance with Cal. Corp. Code § 212(a) prior to entering into a merger or acquisition, that entity may not have obtained the proper approval to enter into a merger or acquisition.

- **Prohibition on Cash-out of Minority Shareholders**. The Cal. Corp. Code prohibits "freeze-outs" or "cash-outs" of the minority shareholders by the majority shareholders. § 1101 of the Cal. Corp. Code requires the unanimous approval of all other target shareholders for a merger if, at any time prior to the merger, the ultimate purchaser of the California target corporation became an owner of more than 50 percent but less than 90 percent of the target's outstanding shares. The Cal. Corp. Code does allow for the possibility of completing the merger without the unanimous approval of the minority shareholders if the California Commissioner of Corporations approves the fairness of the merger at a hearing, but most purchasers would rather avoid the additional delay and uncertainty of a hearing. However, if

the purchaser holds more than 90 percent of the target's outstanding shares prior to the merger, it can complete a short-form merger without any need for separate minority-shareholder approval (as is the case in Delaware). Consequently, any shareholder or group of shareholders that are not the shareholder(s) holding more than 50 percent but less than 90 percent can potentially block a proposed merger transaction, notwithstanding the transaction's approval by the corporation's board of directors and shareholder(s) holding more than 50 percent but less than 90 percent.

- **Dissenting Shareholders' Rights in Merger Transactions**. A shareholder of a California target corporation who opposes a merger transaction can demand that the corporation purchase its shares for "fair market value." The California Court of Appeal has ruled that in no event can a dissenting shareholder make a claim for monetary damages out of its opposition to the merger (*Busse v. United Panam Fin. Corp.*, 2014 WL 60551 (Cal. App. 4th Dist. Jan. 8, 2014)). However, if the merger is a short-form merger involving two parties under common control, a dissenting shareholder can sue under § 1312(b) of the Cal. Corp. Code to rescind the merger. Consequently, if the dissenting shareholder and the corporation do not agree on whether it is entitled to exercise its appraisal rights or on the fair market value of its shares, the shareholder can bring an action in court to resolve those questions.

- **§ 25142 Permit and Hearing Process**. A purchaser's shares issued and exchanged in connection with an acquisition transaction need to be registered with the Securities and Exchange Commission, unless the issuance is exempt from federal and state registration. However, in California, registration may not be necessary, even if an exemption under § 4(2) or Regulation D is not available. California is one of a few states to have its own permit and hearing process for the qualification of the securities to be issued and exchanged in an acquisition transaction. The permit and fairness hearing process can be used if either the purchaser or the target is incorporated in California or has a meaningful presence in California. This process is favored by California practitioners under the appropriate circumstances, including but not limited to companies involved in a merger or acquisition transaction that has high federal registration costs (the process provides a fast and cost-efficient alternative to federal registration, saving companies hundreds of thousands of dollars in federal registration costs). Under this procedure, a purchaser wishing to issue shares in connection with an acquisition transaction can apply for a permit from the California Commissioner of Corporations and request the commissioner to hold a hearing to determine the fairness of the terms and conditions of the issuance and exchange of shares. After completing the fairness hearing and receiving approval from the commissioner, the purchaser may qualify for the following exemptions: (i) registration under § 3(a)(10) of the Securities Act of 1933, (ii) certain requirements for corporate merger transactions under Cal. Corp. Code §§ 1101, subd. (b), 1101.1 and 1113, subd. (c), and/or (iii) the requirement for approval by 90 percent of the outstanding shareholders before or after the board approves the sale, lease, conveyance, exchange, transfer or disposal of all (or substantially all) of its assets under Cal. Corp. Code § 1001. The § 25142 permit and hearing process typically saves a purchaser the significant time and expense necessary for registration and should be considered if available.

- **§ 2115 of the Cal. Corp. Code – Long-arm Statute and Quasi-California Corporations**. § 2115 of the Cal. Corp. Code purports to require certain private corporations incorporated in foreign jurisdictions to comply with various requirements of the Cal. Corp. Code normally applicable only to corporations incorporated in California. A foreign private corporation is subject to § 2115 if (i) more than half its business during its latest full income year is conducted in California, as measured by a statutory formula weighing assets, payroll and sales factors, and (ii) more than 50 percent of its outstanding voting securities are held of

record by California residents. To these “quasi-California corporations,” § 2115 attempts to apply a host of Cal. Corp. Code provisions to the exclusion of the law of the jurisdiction in which the corporation is incorporated. Consequently, this often complicates a deal involving a private target that is headquartered or otherwise has a significant presence in California but is incorporated elsewhere, because it forces the parties to comply with potentially conflicting laws of California and the target’s state of incorporation.

This above list covers just a few of the key issues and considerations. California’s approval mechanics, minority protections, state-specific securities and quasi-California rules can materially affect feasibility, timing and deal terms—particularly for life sciences companies with complex cap tables and regulatory timelines. In Part 2, we turn to dispute-resolution planning, the enforceability of restrictive covenants and California-specific tax considerations that frequently drive structure and negotiations. Stay tuned for Part 2 to see how these issues interact with—and build upon—the topics covered above.