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Equitable Limitations On The Power To Amend Articles Of Incorporation

MICHAEL J. HALLORAN*

Once a corporation is organized, a change in its needs may require an amendment of its articles of incorporation. While the statutory powers to effect such an amendment are broad, they are governed by equitable limitations. In this article, Mr. Halloran presents and analyzes California’s test for granting equitable relief, which he characterizes as a balancing of fairness factors. The author then concludes that in view of applicable case law and Department of Corporations administrative proceedings, in which the equitable factors have been successfully applied, statutory revision in this area is unnecessary at this time.

INTRODUCTION

As corporations attempt to adjust to the rapid changes in the business world, their financial and operational needs may be altered accordingly. These changes in need may dictate an adjustment in stock structure, in rights or restrictions on outstanding shares, or in corporate powers or purposes. In order to effect these changes, an amendment of the articles of incorporation may be required. However, the power given by the California Corporations Code to the board of directors and the holders of the majority of the outstanding shares to

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1. CAL. CORP. CODE §§3600-3604.
amend the articles is restricted by judicially and administratively imposed equitable limitations.

These equitable limitations upon the power to amend the articles of incorporation are the subject of this article. Initially, California's purported acceptance of the Ballantine test for granting equitable relief is discussed. Thereafter, the actual test that California appears to be using is presented in the format of a checklist of fairness factors, which are analyzed and evaluated.

Equitable limitations on the power to amend articles derive from the inherent power of a court of equity to grant injunctive relief in situations where the majority shareholders have acted unfairly toward the minority shareholders. Equitable limitations have been recognized by the California courts, but the courts have had difficulty in pinpointing a precise, workable “test” to determine when equitable relief should be granted.

The California test adopted from Ballantine is said to be the following:

Changes in the rights of outstanding shares may be valid if they can be justified as an exercise of fair business discretion in meeting the needs and exigencies of the corporate enterprise. The more urgent the need or the emergency the more drastic the amendment or adjustment which fairness will permit. . . .

Under the Ballantine test the burden is upon the proponents of the change (usually the management) to demonstrate (1) the business need or exigency requiring the change, (2) the fact that the amendment would appear to meet, or help to meet, the need or exigency, and (3) the fact that adoption of the amendment would appear to be an exercise of fair business discretion in meeting such need. This allocation of the burden of proof appears to be recognized in DeMello v. Dairyman's Co-op Creamery. In DeMello, the court reviewed evidence which indicated that the membership structure of a cooperative


5. The exercise of fair business discretion is determined by weighing the degree of need for the amendment against the degree of change wrought by the amendment. In other words, the lower the business need, the more difficult it will be to establish “fair business discretion” in adopting the amendment.

6. 73 Cal. App. 2d at 751, 167 P.2d at 228-29; accord, Honigman v. Green
resulted in dissension, hampered operations, caused unnecessary payment of taxes, and prevented repayment to dissenting members of the full value of their interest unless dissolution proceedings were commenced. The court also noted that all members were treated alike by the relevant amendment to the articles. It then concluded, "There seems to be nothing unfair in this procedure and it is intended to settle the internal troubles of the association. This brings the case within the rule announced by Mr. Ballantine . . . ." 77

Various tests to determine when equitable relief should be granted have been developed in other jurisdictions. 8 In view of the sparsity of the law in this area in California, these tests might be argued in judicial and administrative litigation in California. An attempt to induce federal courts to use their own unfairness test and not to use the state law tests has failed. 9

Although the case did not involve an amendment to the articles, it is possible that the "fair, just and equitable" standard adopted by the California Supreme Court in Jones v. H.F. Ahmanson & Co. 10 (a pure fairness standard) might apply in future article amendment cases. In support of this proposition it has been argued that the same principles should govern the exercise of the power to amend the articles of incorporation as govern the exercise of the power to engage in a transaction where control is material, as was the case in Jones v. H.F. Ahmanson & Co. 11 The better view is that there is a "spectrum" of fiduciary duties owed by majority shareholders to minority shareholders

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73 Cal. App. 2d at 751, 167 P.2d at 229.
9 Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 202 (D. Del. 1943) ("questions of fairness are matters of substantive law"). This decision makes it clear that the shareholder would have been granted relief if the court applied its own fairness test. The anti-forum-shopping policy evinced in the most recent United States Supreme Court decision in the federal-state law conflict area suggests the result today would be the same as the holding in Barrett, Hanna v. Plummer, 380 U.S. 460 (1965).
and that the standard of duty required in the case of a transaction where control is material is not as demanding a standard as that which exists in the case of the statutory majority of the shareholders adopting an article amendment.\textsuperscript{12}

**Analysis of the Standard**

Although more workable than the other tests that have been utilized, the Ballantine test is, in the opinion of the author, somewhat too generalized. A review of the relevant cases reveals that the Ballantine test includes within it some, but not all, of the factors considered by courts in deciding whether to exercise their equitable powers. In contrast to this general test, an old law review article, written at a time when the "vested rights" doctrine appeared to be the "prevailing rule in the United States," opined that the courts will balance the importance of the right destroyed against the advantage of the change and will discover a vested right when the former overbalances the latter.\textsuperscript{13} It is submitted that this is still the standard except that the courts and administrative agencies are now less inclined to speak in terms of a vested right and are more inclined simply to find the amendment inequitable to the minority.\textsuperscript{14}
The judicial balancing indicated above is accomplished by reviewing several competing factors which will be discussed below. Similar
factors are considered by the California Commissioner of Corporations in determining whether to issue a permit authorizing an amendment\textsuperscript{16} and by courts reviewing a decision of the Commissioner. Thus, the attorney for a corporation that is contemplating an article amendment in order to satisfy some corporate problem or need should consider these factors and recommend to his client the type of amendment most likely to both satisfy the corporate need and survive eventual scrutiny by the Commissioner or the reviewing court. Counsel should draft the amendment in such a way that he can argue the factors in his favor in the event of litigation. Conversely, the attorney for an objecting shareholder, with the following fairness factors in mind, should analyze the amendment, the business conditions of the corporation, and the rights to which his shareholder client will be deprived, so that he can determine whether an attack heard before the Commissioner of Corporations or the courts is likely to succeed.

**THE TEST FOR EQUITABLE RELIEF**

*Corporate Necessity*

An article amendment must be justified by some corporate necessity in terms of a business need or exigency. This is basically the Ballantine test adopted by the court in *DeMello*\textsuperscript{18} and has been utilized in many instances in California. For example, the fact that a corporation was in serious financial difficulties and was facing probable bankruptcy and dissolution justified the elimination of accrued dividends on preferred stock.\textsuperscript{17} In another case, the protection of a close corporation and its shareholders against unwanted intrusions by outsiders justified a reasonable restriction on transfer of outstanding shares.\textsuperscript{18} Further, another corporation in financial reorganization proceedings justified an amendment to its articles, removing restrictions on selling additional shares, presumably for the purpose of raising new capital.\textsuperscript{19} An amendment was allowed by the court (overruling a decision of the Commissioner of Corporations not to permit the amendment) in a case in which an unsuccessful business sought recapitalization to avoid the sale


\textsuperscript{16} See text accompanying notes 4-7 supra.

\textsuperscript{17} Blumenthal v. Di Giorgio Fruit Corp., 30 Cal. App. 2d 11, 18, 85 P.2d 580, 584 (1938) (so-called "voluntary" exchange plan accomplished same result as amendment of articles directly removing accrued dividends).

\textsuperscript{18} Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964).

The asset was in a state of disrepair and decay as a result of payment of dividends out of capital to the preferred stock. The courts have shown considerable interest in whether or not a proposed amendment treats all shareholders alike, or whether there is a different treatment of groups or classes of shareholders evidencing personal gain to the majority at the expense of the minority. For example, a lack of corporate need or business purpose for the article amendment together with discrimination among groups of shareholders has supported the conclusion that the only purpose of the amendment was to discriminate against the minority. On the other hand, in cases in which an article amendment involves a recapitalization followed by issuance of additional shares (authorized by the recapitalization) in order to raise new capital, the giving to each shareholder of

21. Id.
22. King v. Ligon, 180 S.C. 224, 185 S.E. 305 (1936) (banks required amendment eliminating redemption provision as a condition of nonforeclosure of loans); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 142 A. 654 (Ch. Ct. 1928) (business was prosperous, but growing and in need of additional funds for expansion, which could be best obtained by sale of a class of stock with a higher dividend participation and with no redemption provision); Hottenstein v. York Ice Machinery Corp., 136 F.2d 944 (3d Cir. 1943) (business prosperous, but needed refinancing); Bailey v. Tubize Rayon Corp., 56 F. Supp. 418 (D. Del. 1944) (possible expansion could be more easily effected if capital structure were simplified); see generally Latty, Fairness—The Focal Point in Preferred Stock Arrearage Elimination, 29 VA. L. REV. 1, 10 (1942); Orschel, Administrative Protection for Shareholders in California Recapitalizations, supra note 15, at 230 et seq.
23. See DeMello v. Dairyman's Co-op Creamery, 73 Cal. App. 2d 746, 751, 167 P.2d 226, 228 (1946) (“all members were treated alike”); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 108, 460 P.2d 464, 471, 81 Cal. Rptr. 592, 599 (1969) (any use to which majority puts the power of control “must benefit all shareholders proportionately”). See also Page v. American & British Mfg. Co., 129 App. Div. 346, 113 N.Y.S. 734 (1905), where the corporation had two classes of outstanding shares, 8,000 common and 20,000 preferred with a dividend and liquidation preference. The number of common shares was reduced to 2,000 and the number of preferred shares was left intact. The court stated that the reduction should have been borne equally by both classes, regardless of the liquidation preference of the preferred shares, unless there was an express statutory provision authorizing reduction of one class but not another. It is possible that this case may be distinguished on the ground the New York statute was not sufficiently specific as to reduction of one class but not another. The California statute would seem to be sufficiently specific, see Sections 3601(a) and 1905 (c) of the California Corporations Code. It is equally possible, and more probable, that the case demonstrates a strong judicial attitude against disproportionate reduction of the common stock's voting power. In Kennedy v. Carolina Public Service Co., 262 F. 803 (N.D. Ga. 1920), a reduction of preferred stock by two-fifths and common stock by one-fifth was held invalid. See also Strathmore Irrigation Dist. v. Wutchumna Water Co., 111 Cal. App. 688, 701, 296 P. 933, 937-38 (1931), and Note, Intraclass Discrimination in the Elimination of Accrued Dividends, 55 HARV. L. REV. 1196 (1942).
the right to purchase his portion of the additionally issued shares (in effect, a "pre-emptive right") has helped to eliminate judicial and administrative objections, at least where the price for the additionally issued shares has not been grossly unfair.\textsuperscript{25}

\textbf{The Size of the Objectors}\textsuperscript{26}

The courts and administrative agencies tend to be very practical in this area; when the vote in favor of the amendment is overwhelming, or at least when the objecting minority owns a very small amount of the outstanding shares, this factor will weigh heavily in favor of supporting the amendment.\textsuperscript{27} In fact, obtaining the statutorily required vote and having only a small minority objector group are together not only given "great weight" by the courts, but result in a "presumption that the judgment of the governing body of a corporation, whether at the time it consists of directors or majority shareholders, is formed in good faith and inspired by a bona fides of purpose."\textsuperscript{28} In the administrative context, the Department of Corporations also takes careful note of the shareholder vote on any controversial amendment of articles subject to its jurisdiction which effects a change in the rights, preferences, and privileges of, or restrictions on, outstanding securities. Since a permit must be obtained from the Department of Corporations in advance of the shareholder meeting, the Department of Corporations may in some circumstances grant a permit on the condition that specified vote percentages are obtained at the meeting.\textsuperscript{29}

\textsuperscript{25} Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951); see also Farmers' Loan & Trust Co. v. Hewitt, 94 N.J. Eq. 65, 118 A. 267 (Ch. 1922), aff'd, 94 N. J. Eq. 187, 118 A. 926 (App. 1922); Browning v. C.&C. Plywood Corp., 248 Ore. 574, 434 P.2d 339 (1967); See also In re Pacific Mariculture Inc., Cal. Dep't of Corp. File No. SF300 2764; such a pre-emptive right does not, however, allow issuance of shares at a grossly inadequate price, Bennett v. Breuil Petroleum Corp., 99 A.2d 236, 240 (Del. Ch. 1953); Gaines v. Long Mfg. Co., 234 N.C. 340, 67 S.E.2d 350 (1951) (substantial dilution of book value).

\textsuperscript{26} This factor can be more precisely stated as: the size of the negative vote plus a presumption that the majority voting for the amendment acted fairly.

\textsuperscript{27} See Blumenthal v. Di Giorgio Fruit Corp., 30 Cal. App. 2d 11, 85 P.2d 580 (1938), where the holders of 90% of the preferred shares and the holders of 97% of the common shares approved the action; Heller Inv. Co. v. Southern T.&T. Co., 17 Cal. App. 2d 202, 61 P.2d 807 (1936), where there were 3,374 shares for the amendment and several shareholders holding 697 shares who were against it but by the time of trial plaintiff was the only objector; Western Foundry Co. v. Wicker, 403 Ill. 260, 85 N.E.2d 722 (1949), where 97% of preferred voted for elimination of its accrued dividends.

\textsuperscript{28} Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148, 151-52 (Ch. 1943). In Transportation Bldg. Co. v. Daugherty, 74 Cal. App. 2d 604, 613-14, 169 P.2d 470, 476 (1946), the court noted, (a) the lack of any opposition at the hearing before the Commissioner of Corporations on the proposed amendment, (b) a "presumption of fair dealing . . . should control unless it is overcome by contrary evidence," and (c) "that a two-thirds class vote on the amendment was required." See also Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 142 A. 654 (Ch. 1928) (holder of 90% of class adversely affected voted for the action; court applied presumption of good faith in upholding the amendment).

\textsuperscript{29} See note 30 infra.
The fact that a high percentage of the vote was in favor of an amendment may be discounted in determining what, if any, equitable relief will be granted when such a vote is "rigged." For example, when an amendment which benefits common stock at the expense of preferred stock is adopted by a high percentage vote, the fact that two-thirds of the preferred shareholders are also holders of common stock weighs against utilization of the higher vote percentage as a factor in favor of the amendment. This type of factual situation, however, if recognized at the time the corporation is applying for a permit, would probably cause the Department of Corporations to require a higher percentage vote from the preferred shareholders.\textsuperscript{30} The most recent case to base its decision on this factor involved a corporation which had two classes of shares; one publicly held, nonvoting class, and one privately held, voting class. Amendments to the articles were adopted in which both classes were exchanged for voting common stock, but since the privately held shares were surrendering their voting rights, they were given a much more favorable exchange ratio than the publicly held shares.\textsuperscript{31} The court based its decision in part on the fact that although only majority approval by the class of stock adversely affected was required by statute, 92.3 percent of the publicly held nonvoting shares were voted for approval of the amendment, of which the majority owner of the privately held shares and members of his family owned only 20 percent. The court concluded that "no fraud or inequitable conduct was resorted to in consummating the amendment, and the proposed plan was fair, equitable, and beneficial both to the nonvoting . . . stockholders and to the corporation . . . ."\textsuperscript{32}

It should be noted that at least one jurisdiction, New Jersey, which is a strong "fairness test" jurisdiction, discounts obtaining a fixed

\textsuperscript{30} The Department's authority for imposing such a condition is derived from California Corporations Code Section 25141. In Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 192 A. 654 (Ch. 1928) the court noted the lack of any affiliation of the 90% holder of the adversely affected class of stock (who had voted in favor of the amendment) with the other class of stock which would benefit by the amendment. See also, Kennedy v. Carolina Public Service Co., 262 F. 803 (N.D. Ga. 1920), where the court noted that a greater number of preferred shareholders were also common shareholders; McQuillen v. National Cash Register Co., 27 F. Supp. 639, 646 (D. Md. 1939), aff'd, 112 F.2d 877 (4th Cir. 1940), cert. denied, 311 U.S. 695 (1940). See also note 11 supra.

\textsuperscript{31} Honigman v. Green Giant Co., 309 F.2d 667, 671-72 (8th Cir. 1962). The privately held voting shares were exchanged for 1,000 new shares per share held; the publicly held nonvoting shares were exchanged for one new share per share held.

\textsuperscript{32} Id. In reaching this conclusion, the court noted that the corporation had prospered through the years under the management of the owners of the privately held shares, and that the premium received by the privately held shares seemed commensurate with the benefit received by the corporation in having publicly held voting shares (see discussion infra, regarding compensation to minority shareholders for rights to be taken).
percentage of the vote as a relevant factor.\textsuperscript{33} Further, in view of management’s natural superior powers in obtaining proxies, one author regards this factor as irrelevant in determining fairness.\textsuperscript{34} On the other side of the controversy, however, are Ballantine & Sterling who state: “[I]t would seem that if the amendment has received the requisite shareholder vote after a fair presentation of its effect, the Commissioner [of Corporations] should not substitute his judgment for that of the shareholders.”\textsuperscript{35} It is submitted that both positions may be too extreme and that the voting percentage should be weighed in the balance with all other factors in reaching a decision on an amendment.

\textit{Available Alternative That Does Less Harm to Minority Shareholders}

California now has at least two cases in which the availability of a less inequitable alternative was used as a factor in striking down corporate action taken by a majority of the shareholders.\textsuperscript{36} Furthermore, a third California case indicates that if a less inequitable alternative had been argued, the court would have considered it.\textsuperscript{37} On the other hand, one court has held that it is not the function of the court to inquire into alternative plans.\textsuperscript{38} However, it is submitted that this factor has not received the attention it deserves in recapitalization cases\textsuperscript{38a} in that a close analysis of alternative plans would give the court or administrative agency a greater insight into the ultimate fairness of the amendment under consideration. For example, one of the most extensively litigated types of article amendments is that concerning elimination of accrued dividend arrearages. To justify elimination of such arrearages on equitable grounds, the courts have used the argument that the corporation is in financial distress and it must free earnings from the claims of the preferred shareholders before needed capital

\begin{itemize}
\item \textsuperscript{33} Kamena v. Janssen Dairy Corp., 133 N.J. Eq. 214, 31 A.2d 200, 202 (Ch. 1943) (“If such a plan is inequitable to the extent that it shocks the conscience of the court, this court then has the right as well as the duty to enjoin its consummation. It is more a question of fair dealing between the strong and the weak than it is a question of percentages or proportions of the votes favoring the plan.”)
\item \textsuperscript{34} Latty, \textit{Fairness—The Focal Point in Preferred Stock Arrearage Elimination}, 29 VA. L. REV. 1, 22-23 (1942).
\item \textsuperscript{35} H. BALLANTINE & G. STERLING, supra note 4, §295.
\item \textsuperscript{36} Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 110, 113, 460 P.2d 464, 473, 475, 81 Cal. Rptr. 592, 601, 603 (1969); Keller St. Dev., Co. v. Dept. of Investment, 227 Cal. App. 2d 760, 768, 39 Cal. Rptr. 44, 48 (1964) (affirming denial by Commissioner of Corporations of permit where borrowing, as opposed to assessing shares, appeared possible and corporate necessity was lacking).
\item \textsuperscript{37} Blumenthals v. Di Giorgio Fruit Corp., 30 Cal. App. 2d at 18, 85 P.2d at 584 (indicating that if some other plan for accomplishment of the objectives had been before the court, the court would have considered it).
\item \textsuperscript{38} McQuillen v. National Cash Register Co., 27 F. Supp. 639, 647 (D. Md. 1939).
\item \textsuperscript{38a} One case has held it is not the function of the court to inquire into alternative plans. McQuillen v. National Cash Register Co., 27 F. Supp. 639, 646 (D. Md. 1939).
\end{itemize}
can be raised by the sale of additional common stock or securities convertible into common stock. Some writers have said that although on its face such an argument has merit, they have discovered no case where such financing has followed the recapitalization plan. In addition, an alternative means of obtaining financing—long-term borrowing for example—which would not be affected by the claim of the preferred shareholders to the accrued dividends may be available. In other words, in this area of the law, the courts, and to some extent the administrative agencies, have given greater weight to the first fairness factor set forth above (corporate necessity) without looking to the possibility that an alternative plan could accomplish the desired result. Of course, if a corporation could show that it was unable to obtain long-term borrowing on reasonable terms and that it therefore had to resort to the sale of equity securities or securities convertible into its equity securities, then the court would be justified in giving much greater weight to the corporate necessity than to the possibility of an alternative plan.

Compensation to Minority Shareholders for Rights to be Lost—
The “Compensatory Principle”

In justifying a recapitalization plan, counsel for the majority shareholders and the corporation should be able to point to some factor which compensates the minority shareholders for the rights they are relinquishing. The utilization of this factor requires an assessment of the value of the rights lost and the value of what is given in return.

40. Hottenstein v. York Ice Machinery Corp., 136 F.2d 944, 946, 952-53 (3d Cir. 1943) (lost the right to accrued dividends; but the equity interest increased from 24% to 83%, thus giving control to the preferred stock); McQuillen v. National Cash Register Co., 27 F. Supp. 639, 646, 647 (D. Md. 1939) (lost the right to accrued dividends but gained: an increased equity interest in the company; the permanent right to vote for directors rather than simply having such a right in the event of default; and the right to participate equally in dividends); Zobel v. American Locomotive Co., 184 Misc. 323, 44 N.Y.S.2d 33 (Sup. Ct. 1943) (lost the right to accrued dividends and voting control passed to the preferred stock; but nonredeemable shares were made redeemable); Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148, 151-52 (Ch. 1943) (the preferred's accrued dividends were taken away, but voting control passed to the preferred). Bailey v. Tubize Rayon Corp., 56 F. Supp. 418 (D. Del. 1944) (lost the liquidation preference but gained voting control); Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 202-04 (D. Del. 1943) (preferred stock already had voting control, and even though the preferred was given an increased equity interest, the court would have held the plan unfair because of the lack of compensation to the preferred for loss of its right to accrued dividends, but the court was constrained to
The courts sometimes give too great an emphasis to the second fairness factor discussed above (disproportionate treatment of classes or groups of shareholders) and forget the compensatory principle; on the other hand, the courts sometimes give too great an emphasis to the compensatory principle and forget the disproportionate treatment of groups of shareholders. For example, all cases considering the issue recognize that there are equitable limitations on the power to reduce capital and to amend articles to accomplish this result. These “reduction of capital” cases uniformly enunciate a rule that each shareholder must be left with the same proportionate interest as others of his own or different classes of outstanding shares. However, defining what that proportionate interest should be is very difficult. One court looked at it in terms of proportionate interest in the assets of the corporation in the event of liquidation; thus, in *Page v. Whittenton Mfg. Co.*,\(^\text{41}\) since preferred shareholders had a liquidation preference, the common stock was the only class of stock which had to be reduced.\(^\text{42}\) Another court looked at the problem in terms of voting power; thus, even though the preferred stock had a liquidation preference, and even though (in accordance with the dictates of *Page v. Whittenton Mfg. Co.*) only the common stock was reduced, this action was held invalid because it reduced the proportionate vote of the common stock.\(^\text{43}\) The way to satisfy both

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\(^\text{41}\) 211 Mass. 424, 97 N.E. 1006 (1912).

\(^\text{42}\) In *Page v. Whittenton Mfg. Co.*, 211 Mass. 424, 97 N.E. 1006, 1007-08 (1912), a corporation required new capital or faced the danger of liquidation. It had two classes of outstanding shares, 8,000 common and 2,000 six percent cumulative preferred with a liquidation preference. It was proposed to adopt an amendment to reduce the stated capital and in connection therewith to reduce the number of authorized outstanding common shares to 1,000 leaving the preferred shares intact, then to adopt an amendment increasing the authorized number of common shares and give both classes on a pro rata basis the right to subscribe to it. The court stated it would not have allowed the plan, but would have required the capital reduction to be borne equally by both classes of stock, if the preference of the preferred stock had been only as to dividends. But since the common could not participate upon dissolution until the liquidation preference of the preferred was satisfied, and since unless the amendment was adopted the corporation might be forced into liquidation in any event, the court concluded the “contract” between the classes of shareholders was that the common “assumed the burden” and therefore “must be first restored to even to the point of extinction before the preferred can be compelled to contribute.” The court, in effect, adopts the “absolute priority” theory in insolvency reorganization. See 11 Fletcher’s *Cyclopedia of Corporations* §5150 (1971).

\(^\text{43}\) See discussion of *Page v. American & British Mfg. Co.*, at note 23 *supra*; where although the preferred had a liquidation preference the court stated that the re-
these cases is in effect to adopt the compensatory principle. For example, the number of shares of common stock could be reduced because of the liquidation preference of the preferred (thus giving the common stock less of an interest on liquidation), but in order to maintain its proportionate voting strength and to somewhat compensate it for the reduction it could be given an increased vote (if necessary, by giving it a greater number of votes per share). The "absolute priority" formulation (common must first be resorted to where preferred has liquidation preferences) is too rigid in that it treats the common shareholder as if the corporation were being wound up, without giving any consideration to the common shareholders' interest in the future of the enterprise as a going concern. The compensatory principle removes attention from the disproportionate treatment factor by compensating the common shareholder for the rights that are being taken away from him.

Another approach to the compensatory principle is for a corporation in adverse circumstances to utilize the various standards developed for insolvency reorganizations when it desires to recapitalize in order to insure fairness and appropriate compensation to all the classes concerned. The compensatory requirement is also considered by the California Department of Corporations in its administrative review of recapitalizations subject to its jurisdiction.

The foregoing discussion does not mean that all recapitalization plans must contain a tangible compensatory element given to the shareholders who are required to give up their rights. In some cases, the value of the rights lost may be minimal so that other fairness factors (such as a lack of discrimination among shareholders and corporate necessity) may outweigh this factor. In other cases, such as a situation of greatly impaired capital, the minority may hold a class of stock which has been reduced to "a shadow of equity" due to the liquidation (or other) preferences of another class of stock. In such a case, a capital reduction which would take away some of the rights of the common stockholder should have been borne equally by both classes. See also 11 Fletcher's Cyclopedia of Corporations §§5149, 5302 (1971).

44. See State v. Bechtel, 31 N.W.2d 853 (Iowa 1948) where a reclassification plan calling for the conversion of preferred with accumulated dividend arrearages to common at a favorable exchange ratio was found inequitable and enjoined where the arrearages were twice the assets of the company so that the court thought the existing common stock was "worthless" and ordered it cancelled. Such treatment gives no recognition to the compensatory principle.


shareholder might be upheld without any specific compensatory benefit to the common shareholders other than the general financial advantage of saving the enterprise.\(^4\) In other words, there may be cases where the compensating element is simply the fact that the corporation is now given the opportunity to raise new capital and proceed on its course instead of commencing dissolution or receivership proceedings. This is not the same as saying, however, that the corporate necessity outweighs the compensatory principle under these circumstances.

**Fair Disclosure to Shareholders**

Fairness to shareholders in the disclosure of the plan to amend prior to obtaining their vote of approval is a prerequisite to sustaining the fairness of the action taken.\(^5\) This philosophy is carried out in Section 3637 of the California Corporations Code which provides that in connection with obtaining the consent of the shareholders to an amendment, the corporation must mail to each shareholder a concise summary of the proposed amendment, the changes to be effected by the amendment, and an indication of any resulting change in the rights of shareholders. However, Section 3637 provides that the failure to comply with it does not invalidate the amendment.\(^6\)

**Market Prices and Financial Analysis**

Where more than one class of shares will be affected by an article amendment and where such shares are traded upon the over-the-counter market or on a national securities exchange, their respective prices may be a good indication of what investors think is the relative value of the two classes of stock. If the exchange ratio is exactly proportionate with the ratio of the prices, it may be easier to justify the amendment plan. In addition, use of financial analysis tests (such as capital-

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\(^4\) Ballantine on Corporations §269 (Rev. ed. 1946).

\(^5\) See State v. Bechtel, 31 N.W.2d 853, 857, 859 (Iowa 1948), where the court held that the holders of the preferred were not "fully and fairly informed of the nature, plan or of the probable effect upon the value of the stock held by them" of the reclassification and further held it was "somewhat significant" that the management proxy did not provide for voting against the amendment; Note, Fiduciary Duty of Directors—Amendments to Articles of Incorporation Ineffective Without Adequate Disclosure to Shareholders, 47 Iowa L. Rev. 1110 (1962), discussing Berger v. Amana Society, 111 N.W.2d 753 (Iowa 1961). In California, the case for this proposition is Transportation Bldg. Co. v. Daugherty, 74 Cal. App. 2d 604, 607-08, 169 P.2d 470, 472-73 (1946), where the court noted the full disclosure made to shareholders and a lack of objectors.

\(^6\) But see, J.I. Case Co. v. Borak, 377 U.S. 426 (1964), where the Securities Exchange Act of 1934 was held to authorize either rescission or damages with respect to a consummated merger authorized pursuant to a proxy statement alleged to contain false and misleading information; Fleischer, Federal Corporation Law: An Assessment, 78 Harv. L. Rev. 1146 (1965); Loss, The SEC Proxy Rules and State Law, 73 Harv. L. Rev. 1249, 1277 (1960).
izing projected earnings at an appropriate multiplier) may give the court or administrative agency additional insight into whether the recapitalization is justified. By use of price ratio and financial analysis tests, a Delaware court justified the reclassification into common stock of a class of stock which previously had a liquidation preference, while leaving other common stock outstanding. The court noted that the exchange ratio was exactly in proportion to the prices on the securities exchange and that, upon capitalizing the projected earnings at six percent, the liquidation preference was not impaired and the common stock was not under water; thus, the court held that there was no reason to resort to elimination or reduction of the common stock in connection with the recapitalization. In addition, turning to the compensatory principle, the court noted that the class with the liquidation preference obtained voting control (78.7 percent) of the common shares.\(^5\)

**Hindsight**\(^6\)

In most cases a court or administrative proceeding will commence before the adoption of an article amendment. However, where the plan has already been put into effect, the successful continued operation of the enterprise as a consequence of the plan will weigh in favor of its proponent.\(^7\)

**EVALUATION OF EQUITABLE RELIEF**

It is appropriate to ask whether review of article amendments on equitable grounds is working adequately, or whether fairness demands statutory revision to strengthen the minority shareholders' ability to obtain adequate judicial or administrative review. Based upon a review of applicable case law and certain administrative proceedings before the Department of Corporations, and to a lesser extent upon the author's experience in this area, the system appears to be functioning adequately and it seems that statutory revision is not necessary at this time. The most recent California case in this area, *Bixby v. Pierno*,\(^8\) tends to confirm

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6. *Blumenthal v. Di Giorgio Fruit Corp.*, 30 Cal. App. 2d 11, 18-19, 85 P.2d 580, 584-85 (1938) (continued corporation operations as a result of the plan instead of liquidating, and started paying dividends). See also, *Metzger v. George Washington Mem. Park, Inc.*, 380 Pa. 330, 110 A.2d 423 (1955), where preferred stock had voting rights share-for-share with common in the event of default on four semi-annual dividends—for ten years prior to the amendment there had been such a default; the amendment gave the preferred the permanent right to vote share-for-share with the common and was upheld by the court partly on the ground that the corporation had been far more successful under the joint management of the preferred and common stock than under the management of the common stock alone.

7. *4 Cal. 3d 130, 481 P.2d 242, 93 Cal. Rptr. 234 (1971).* In reaching this conclusion, the author is cognizant that there are a number of exceptions from the qualifica-
this conclusion. Evaluation of the fairness factors in that case reveals that the decision was a very close one indeed, but that the result is defensible and probably correct.

In *Bixby* the majority of shareholders in a closely held corporation desired to maintain continuity of management and ownership. The problem the corporation desired to overcome was the sale of voting stock to outsiders by the estates of decedent shareholders in order to meet the cash needs of the estates.

The solution was to adopt an amendment to the articles by approval of the holders of 70 percent of the outstanding shares, creating a new class of nonvoting preferred stock having a large liquidation preference, a $5 cumulative annual dividend and a $2 noncumulative dividend per share. The new preferred shares were distributed pro rata to the shareholders. In the event of a shareholder's death, his estate could elect to sell the valuable preferred stock to pay the taxes and costs, and retain the voting common stock for distribution to the heirs.5

A hearing on fairness was held before the Department of Corporations which granted a permit authorizing the plan. The hearing officer relied to a great extent on the corporate necessity factor and held that this outweighed certain adverse effects of the plan. The hearing officer also noted the size of the vote (70 percent) and the disclosure provided by a proxy statement to all shareholders.55

The corporate necessity assertion in *Bixby* was that stability of ownership was required to assure continuity of management so that long-term projects could be developed and implemented. This corporate need appears to be no more compelling than that in *Tu-Vu Drive-In Corp. v. Ashkins*,56 except to the extent that in *Bixby* long-term real estate development projects existed which required continuity of management. It is difficult, however, to gauge the importance of this factor. One may argue that since the actual development would be performed by outside builders, continuity of management of the real estate

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54. *Id.* at 135, 481 P.2d at 245, 93 Cal. Rptr. at 237.
55. *Bixby v. Volk*, 78 Cal. Rptr. 606, 609 n.3 (Ct. App. 1969) (order for limited trial *de novo* on petition for mandamus vacated on hearing granted by supreme court: Pierno substituted for Volk as Commissioner of Corporations).
56. See text accompanying note 18 *supra*. 
owner would have no bearing on the success of development since long-term contractual development commitments would be binding upon the present and future management of the owner-corporation. It could be countered that a builder requires assurance of a continuous flow of progress payments from a management he knows and trusts; however, it is difficult to conceive of substantially long-term building commitments under most circumstances (usual commitments for commercial or residential structures run from six months to three years) unless the construction is of major proportions (e.g., development by one builder of an entire city over a 20 year span). The case does not disclose any such extraordinary long-term development activity. Accordingly, one may question whether the alternative presented by the Tu-Vu decision—a simple right-of-first-refusal provision—would have accomplished the desired result with less harm to the minority shareholders than the solution adopted by the majority shareholders in Bixby v. Pierno.

In attempting to answer this question it is important to note that in Bixby the action taken treated all shareholders alike. A minority shareholder's estate could pay its taxes without giving up voting interest. Such a pro rata distribution of the preferred stock is akin to a preemptive offering of a new class of shares and eliminates any discrimination objections. Further, the majority stockholders in the corporation owned 52 percent of the shares. Since 70 percent of the shares were voted to approve the plan, at least 18 percent of the minority shares were voted to approve it. It also appears that there were two plaintiff objectors who did not hold all of the 30 percent which was voted not to approve the plan and it is possible (although the case does not make it clear) that the plaintiffs did not represent a majority of the minority.

It is submitted that, although not precisely articulated in the decision of the hearing officer, in view of the less than compelling corporate necessity or exigency as discussed above (and as contrasted to Tu-Vu), the deciding factors were: (1) the fact that all shareholders were treated alike, (2) the presumption that the 70 percent voting for the amendment acted fairly, and (3) the fact that the alternative adopted was not materially more onerous than any other available alternative, e.g., a Tu-Vu right-of-first-refusal provision actually would

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57. Bixby v. Pierno, 4 Cal. 3d at 135, 481 P.2d at 245, 93 Cal. Rptr. at 237 ("each shareholder will possess the same ownership interest, rights and privileges as he formerly possessed").
58. See text accompanying note 25 supra.
59. Bixby v. Pierno, 4 Cal. 3d at 148, 481 P.2d at 255, 93 Cal. Rptr. at 247 ("the decision to adopt such a plan must derive initially from the sound business judgment of the directors and the required majority of the shareholders").
restrict free transferability (and therefore, liquidity) while the *Bixby* plan appears to facilitate liquidity and free transferability of the shareholder's interest.

The minority shareholders obtained judicial review of the decision of the Department of Corporations by asking for a limited trial *de novo* (independent judgment review) by the court of the evidence relating to the matter. The court of appeals granted a *de novo* review on the ground that a vested interest of the shareholders was affected, namely, the plaintiffs had shown: (a) the combined value of their common plus preferred stock was less than the value of the common stock alone, and (b) there was a possibility of adverse tax consequences as a result of distribution of preferred stock.\(^6\) The California Supreme Court gave the Department of Corporations an important victory by holding that a *de novo* review of its decisions on recapitalizations was not required, and that the Department's decisions should be reversed only if its findings were not supported by substantial evidence or were arbitrary, capricious or fraudulent. The supreme court determined that the Commissioner of Corporations was entitled to conclude that the advantages outweighed the adverse effects (*i.e.*, the rights lost as a result) of the plan.\(^6\) This decision appears to prevent complete relitigation before the courts of recapitalization matters subject to the jurisdiction of the Department of Corporations. Certainly one of the purposes of an administrative review is to remove such issues from overburdened courts and place them into the hands of an agency which has acquired expertise in dealing with these matters on a day-to-day basis, thereby leaving for judicial review cases in which the decision of the Department is not supported by substantial evidence.

**Conclusion**

By a conscious use of the fairness factors discussed above, the courts, administrative agencies, and courts called upon to review an administrative agency's decisions, may reach equitable results based upon grounds which are more acceptable to litigants than the obsolete "vested rights" formulations and decisions which were based upon undue concentration on one factor without weighing it against other factors. The above list does not purport to be complete. However, it is hoped that it will channel attention to those factors which make a substantive difference in the area of fairness of article amendments to shareholders.

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\(^6\) Bixby v. Volk, 78 Cal. Rptr. at 609, 611.
\(^6\) Bixby v. Pierno, 4 Cal. 3d at 150, 151, 481 P.2d at 256, 257, 93 Cal. Rptr. at 248, 249.