

Memorandum

To: Mr. Vern Walton

Date: February 20, 1985

From: Richard Ochsner

Subject: Separation of Voting Rights From Stock Ownership

This is in response to your memorandum of July 20, 1984, requesting advice on whether an irrevocable stock proxy transferring the stock voting rights, without an accompanying transfer of the equity or ownership interests represented by the stock, could qualify as a change in ownership of the real property owned by the corporation under Revenue and Taxation Code Section 64.

A preliminary question, of course, is whether an irrevocable proxy is a legally effective means of transferring shareholder voting rights in a corporation. The General Corporation Law is found in the California Corporations Code commencing with Section 100. Provisions dealing with the voting of shares are found in Chapter 7 of the General Corporation Law commencing with Section 700 of the Corporations Code. Section 705 of that code (copy attached) deals with the subject of proxies.

Subdivision (a) of Section 705 states the general rule that every person entitled to vote shares may authorize another person or persons to act by proxy with respect to such shares. Subdivision (e) and (f) of Section 705 deal specifically with irrevocable proxies. Subdivision (e) provides that a proxy stating that it is irrevocable is irrevocable for the period specified when held by any one of six enumerated classes of persons. These are: (1) pledgees; (2) purchasers or sellers of the stock; (3) creditors of the corporation or of the shareholder; (4) persons contracting to perform services, as an employee of the corporation; (5) persons subject to certain voting trust agreements described in Corporations Code Section 706; and, (6) beneficiaries of a trust holding the shares for which the proxy is given. Subdivision (e) further provides that a proxy may be made irrevocable if it is given to secure the performance of a duty or to protect a legal or equitable title until the happening of events which discharge the obligation secured by it. The subdivision also states that an irrevocable proxy become revocable, in spite of the period of irrevocability specified in the instrument, when a specified event occurs which removes the condition which originally qualified the person for an irrevocable proxy. For example, the proxy becomes revocable when the pledge is redeemed, the debtor relationship is terminated, the Section 706 agreement is terminated, etc. Finally, subdivision (f) permits revocation of an irrevocable proxy by a transfer of the shares without knowledge of the proxy, unless the existence of the proxy and its irrevocability appears on the certificate representing the stock shares.

It is clear, therefore that irrevocable proxies are legally effective only under the limited conditions described. Whether a particular irrevocable proxy constitutes a valid transfer or voting power, separate from the ownership of the stock, will depend upon facts of each case. For the

remainder of this discussion, however, it will be presumed that an irrevocable proxy satisfies the conditions of Section 705.

Subdivision (a) of Section 64 generally provides that the purchase or transfer of ownership interests such as corporate stock does not constitute a transfer of the real property of the corporation. Exceptions are subdivisions (c) and (d) of Section 64, and subdivision (h) of Section 61. The latter deals with the special situation of a transfer of stock of a cooperative housing corporation and need not be discussed here. Further, subdivision (d) of Section 64 deals with a specifically described situation. It applies only where property is first transferred to a legal entity in a transaction excluded from change in ownership by paragraph (2) of subdivision (a) of Section 62 (a change in the method of holding title with no change in proportional interests), and then "shares or other ownership interests representing cumulatively more than 50% of the total interests in the entity are transferred by any of the original co-owners in one or more transactions...." The reference in this subdivision is expressly to transfers of shares or other ownership interests". I have doubt at this point that a reappraisal of the underlying corporate real property could be triggered under the terms of this provision solely by an irrevocable stock proxy transferring voting rights. We are left, therefore, with subdivision (c) as the focus of this analysis (We note that the last paragraph of subdivision (d) provides that a transfer of shares which results in a change in control of a corporation is subject to subdivision (c) rather than subdivision (d).)

In pertinent part, subdivision (c) provides that a change in ownership of the property owned by a corporation occurs when a corporation, partnership, other legal entity or person obtains "control" of the corporation. "Control" is defined by reference to Revenue and Taxation Code Section 25105 which states that "Direct or indirect ownership of control of more than 50% of the voting stock of the taxpayer shall constitute ownership or control...."

Thus, a subdivision (c) change in ownership is based upon the acquisition by a single entity or person of control of the corporation through the direct or indirect ownership or control of more than 50% of the corporate voting stock. Since the language adopted by the Legislature does not expressly refer to voting rights or stock proxies, the question presented is whether the Legislature intended to include such rights or proxies within the scope of its definition of "control." Put another way, the question is whether the acquisition of the voting rights or more than 50% of a corporation's voting stock through an irrevocable proxy constitutes direct or indirect control of the stock for purposes of the definition of "control" adopted by the Legislature. We conclude that the answer is affirmative.

The standard adopted by the Legislature in subdivision (c) of Revenue and Taxation Code Section 64 is the acquisition by a single person or entity of "control" of the corporation as evidenced by the ownership or control of more than 50% of the voting stock. Control of a corporation exists, of course, at a variety of levels. For example, the chief executive officers of a corporation normally controls the day-to-day operation and policies of the company. But that officer serves at the pleasure of the corporation's board of directors. Thus, the board of directors, or its majority, has the power to control the corporation through the chief executive officer. It is well recognized, however, that the ultimate control of the corporation rests with its stockholders, and this is the level of control referred to in subdivision (c).

A majority shareholder is entitled to elect a majority of the board of directors (see Corporations Code Section 708 requiring cumulative voting for corporate directors) and therefore has the power to control the operation of the corporation and make decisions which bind and control the interests of the minority shareholder. (Graham v. Pasadena Land and Water Company, 152 Cal 596, 93 Pac 498). Further, the consent of a majority of the voting shares is required to authorize a variety of major corporate actions such as: a consolidation or merger (corporation Code section 3632); and, a reduction in stated capital (Corporations Code section 1904). Finally, a majority of the voting stock may elect to dissolve the corporation (Corporations Code section 4500).

The change in ownership test employed by the Legislature in subdivision (c) of Section 64 refers to the ownership or control of a majority of the voting stock and this reference is apparently based upon the control of corporate affairs normally granted to the majority shareholder. This control arises from the power to elect a majority of the board of directors and to thereby control the operations of the corporation and make other major corporate decisions such as merger, sale of assets, etc. This kind of control is not dependent upon participation in the other normal incidents of common stock ownership, such as participation in dividends or distribution of corporate assets. Thus, where the stock voting rights are separated from these other incidents of stock ownership, we conclude that the Legislature intended that the test follow the voting rights.

While we conclude that a transfer of the voting rights of more than 50% of the voting stock by means of an effective irrevocable proxy can constitute a change in ownership, it should be recognized that there are a number of exceptions which might apply. For example, one of the classes of persons to whom an irrevocable proxy may be given is a creditor of the corporation or shareholder where the proxy is given in consideration of an extension or continuation of credit. (See Corporations Code section 705, subdivision (e)(3).) Subdivision (c)(1) of the Revenue and Taxation Code section 62 provides, however, that a change in ownership shall not include the creation, assignment, termination, or reconveyance of a security interest. Thus, where the irrevocable proxy is transferred in connection with a true security transaction, the transfer would not constitute a change in ownership because of the provisions of Revenue and Taxation Code section 62 (see also Property Tax Rule 462(k)(1).) Another exception might arise where the transferee of the irrevocable proxy is under a contractual or fiduciary duty to exercise the voting rights solely for the benefit of the owner of the corporate shares. Where the transferee of the proxy has only limited discretion when exercising the voting rights, then those limitation must be examined to determine whether true control has actually transferred. For those reasons, we believe that each transaction involving a transfer of voting rights by means of an irrevocable proxy must be carefully examined and our decisions in this area should be made on a case-by-case basis.

In the first example you cite, A and B each own 50% of the voting stock of the corporation. On B's divorce, his wife receives one half (25%) of B's stock. The corporation then purchases the stock from B's former spouse and retires it. This leaves B with one third (25%) and A with two thirds (50%) interest. A then transfers to B, by irrevocable proxy, sufficient voting rights to make them equal in voting power.

Two things come to mind under these facts. First, unless the irrevocable proxy were issued prior to the point in time when 25% of the corporation stock was redeemed and retired, a change in ownership occurred as soon as A become a two thirds owner. A Subsequent transfer of voting rights would not change that result Second, the facts do not show that B falls within one of the classes of person described in Corporations Code section 705(e) as qualified to hold an irrevocable proxy Thus, the legal effectiveness of the irrevocable proxy is in question. In conclusion, a change in ownership under these facts could be avoided only if the irrevocable proxy is legally effective and if it is issued before A become a two thirds owner.

In your second example, A owns 10% and B owns 90% of the stock in the corporation. For an unspecified reason, B transfers the voting rights to all of his stock by irrevocable proxy, to A. Assuming, (a) that the irrevocable proxy satisfies the requirements of Corporations Code section 705(e), and (b) that this is not a security transaction, then it would appear that the transfer of voting rights from B to A would constitute a change in ownership under the interpretation set forth above. A final decision in this matter would, of course, require a detailed examination of all the facts in this matter together with any supporting documentation, such as contracts, escrow agreements, etc

Finally, it appears that this interpretation will be the controlling precedent for the foreseeable future. We have abandoned an earlier proposal to seek clarifying legislation on this subject.

RHO: mw

Attachment

cc: Mr. James Delaney
Mr. Gordon Adelman
Mr. Robert Gustafson
Ms. Michele Hicks
Mr. Eric Eisenlauer