CORPORATE COUNSEL

An ALM Website

corpcounsel.com | December 23, 2014

Of Long Arms and Internal Affairs

From the Experts

Adam R. Moses, Haig Maghakian and Mark Vible

To their chagrin, some out-of-state corporations doing business in California may be obligated to comply with a number of corporate governance requirements normally applicable to California corporations only. These requirements are imposed by California's controversial "long-arm statute"—Section 2115 of the California Corporations Code—which, although recently critiqued and challenged, remains on the books and should be carefully considered by legal practitioners advising companies with operations in the state.

With the exception of publicly traded companies, Section 2115 applies to any out-of-state corporation in which (i) more than one-half of the voting securities are held by California residents, and (ii) more than one-half of the business activity is conducted in California (as determined by weighing property, payroll and sales factors for the most recent full income year). Section 2115 can even apply to a parent corporation that conducts no business of its own in the state, if it has a subsidiary that meets these minimum contacts factors.

For out-of-state corporations subject to Section 2115—sometimes described as "quasi-California corporations"—the statute requires compliance with various provisions of California corporate law "to the exclusion" of the law of the corporation's home state. At the same time, a corporation's home state generally requires compliance with provisions of its own corporate law, which can directly conflict with the California provisions imposed by the long-arm statute. In this regard, Section 2115 takes aim squarely at the "internal affairs doctrine" prevailing in most other states.

The internal affairs doctrine is a choice of law principle that generally requires courts to apply the law of the state in which a corporation was organized to issues involving the internal corporate affairs of that business (i.e., the relationships between the corporation and its officers, directors and shareholders). Because of this tension between California's long-arm statute and the internal affairs doctrine of other states, both the constitutionality and enforceability of the long-arm statute have been called into question by various courts both in and outside of California.

In the 2005 case *VantagePoint Venture Partners 1996 v. Examen Inc.*, the Delaware Supreme Court considered the application of Section 2115 to a Delaware corporation that was doing business in California. Holding that only the state of incorporation has the authority to regulate a corporation's internal affairs, the court categorically rejected the applicability of the long-arm statute to Delaware corporations. In reaching its decision, the court criticized Section 2115 as "apt to produce inequalities, intolerable confusion, and uncertainty." Then, going a step further, the court challenged the constitutional validity of the long-arm statute by indicating that it violates the constitutional principles upon which the internal affairs doctrine is based—namely, that directors, officers and stockholders have a right to know what law governs their corporation.

Since *VantagePoint's* rejection of Section 2115, no California court has directly addressed the statute's enforceability or constitutional validity. However, in the 2012 case *Lidow v. Superior Court*, the California Court of Appeals took the opportunity to agree with a key part of the *VantagePoint* decision when it stated in dicta that "courts must apply the law of the state of incorporation to issues involving corporate internal affairs." Because the court ultimately determined that the issue in dispute did not involve "corporate internal affairs," such as voting rights of shareholders or the payment of dividends, the decision in *Lidow* did not expressly reject Section 2115. Nevertheless, *Lidow's* favorable treatment of the *VantagePoint* decision leaves open the possibility that some California courts could be disinclined to enforce the long-arm statute in future litigation involving a corporation's internal affairs.

In light of these recent judicial challenges, in a proactive move the California Assembly unanimously passed legislation in 2012 to repeal Section 2115 "before the federal courts strike it down and the state is forced to spend additional taxpayer dollars" defending it. To further justify repealing the statute, the California Assembly emphasized the complexity and uncertainty—plus the resulting costs and increased risk of doing business in California—created by the long-arm statute. Specifically, the Assembly noted that Section 2115 often has the effect of forcing quasi-California corporations to govern themselves by the different and potentially conflicting laws of California and their home states. This, together with the uncertainty created by the "transient nature" of the statute's applicability (i.e., a fresh determination of whether a corporation is subject to the statute must be made every year based on the current property, payroll and sales factors), can result in added expense for companies. The Assembly also expressed concern that, in an effort to avoid this sticky situation and opt instead for the predictability provided by the internal affairs doctrine, many out-of-state corporations may consciously work to keep enough of their property and employees in states other than California so as to ensure that the minimum contacts factors set forth in Section 2115 are never met and that, accordingly, they are not subject to the long-arm statute.

Nevertheless, the Senate Judiciary Committee ultimately rejected the legislation, stressing that repealing the statute would eliminate the protections it affords to California shareholders and provide "yet

Corporate Governance Requirements: Section 2115 vs. Delaware
Explanatory Note: This table is intended to illustrate that conflicts exist between some provisions of Section 2115 and Delaware law and is not intended to be, and is not, a comprehensive account of all such conflicts or a summary of Section 2115 in its entirety. This table does not include every provision of Section 2115 nor does it cover every difference between California and Delaware corporate law.

Requirement	California / Section 2115	Delaware
Shareholder Vote Requirements for Merger Transactions	With the exception of short-form mergers, a merger transaction must be approved by each class of the corporation's outstanding shares. *(Note: This means that even a class of nonvoting shares has the right to vote on a merger.)*	Unless the charter provides otherwise, a merger transaction can be approved by a majority vote of all the outstanding shares entitled to vote.
Other Limitations on Mergers	If the acquirer holds more than 50% but less than 90% of the target's outstanding shares before a merger, then unanimous approval of all other shareholders is required to approve the merger.	Even if the acquirer holds more than 50% of the target's outstanding shares, a merger transaction can still be approved by a majority vote of all outstanding shares.
Dissenters' Rights	The appraised value of the dissenting shares must be their fair market value on the day before the merger announcement.	The appraised value of the dissenting shares may be determined by considering all relevant factors, with no specific date requirement.
Election of Directors	Cumulative voting is always required.	Cumulative voting is not required but is permitted if the charter provides for it.
Removal of Directors Without Cause	Directors may be removed without cause by a majority vote of the stockholders.	Unless the charter provides otherwise, directors may not be removed without cause if the board is staggered.
Director Indemnification	Indemnification is required to the extent that the defendant is successful in defending against the litigation "on the merits."	Indemnification is required to the extent that the defendant is successful in defending against the litigation "on the merits or otherwise."
Limitations on Corporate Distributions	Subject to certain qualifications, a dividend is generally permissible if: - It equals or is less than the amount of retained earnings before the distribution or - After the distribution, the corporation's assets exceed the sum of its liabilities and the liquidation preference of any shares that have a preference upon dissolution over the shares to which the distribution is being made	Subject to certain qualifications, a dividend is generally permissible if: - It passes the "balance sheet" test, which examines whether the distribution can be charged to any surplus account or - It is a so-called "nimble dividend" (i.e. it is declared out of net profits for the current or preceding fiscal year)

another incentive" for businesses to incorporate outside of California. Thus, in spite of the criticisms and challenges leveled against it, Section 2115 remains on the books.

In addition to the judicial and legislative attention it has received lately, California's long-arm statute has sparked debate among its critics and defenders in the commentariat and academic journals. For example, in his Seton Hall Law Review comment, "The Constitutionality of Outreach Statutes Under the Dormant Commerce Clause," Jason S. Haller argued that Section 2115 should be recognized as a "narrowly tailored" exception to the internal affairs doctrine. Haller reasoned that statutes such as Section 2115 provide states with the "ability to protect their domestic corporate actors" and "promote internal practices that facilitate sound corporate decision-making." Meanwhile, the statute drew criticism from John W. Edwards II in the U.C. Davis Business Law Journal. In his article entitled "Busy Bees and Busybodies: The Extraterritorial Reach of California Corporate Law," Edwards described Section 2115 as "an ill-conceived experiment whose time has passed" and criticized the "uncertainty and dysfunction" that the long-arm statute has brought to "an area of the law that requires the certainty and predictability inherent in the Internal Affairs Doctrine."

Despite the various rebukes it has drawn, the long-arm statute's champions have thus far prevailed. With that in mind, a table summarizing various corporate governance requirements that Section 2115 foists upon qualifying out-of-state corporations doing business in California is provided below. Corporations doing business there would do well to study it. In addition, recognizing that many of these corporations are organized under the laws of Delaware, the table highlights key differences between the long-arm requirements and the corresponding provisions of Delaware law that they purport to supplant:

Adam R. Moses is a corporate partner, Haig Maghakian is a financial restructuring associate and Mark Vible is a corporate associate in the Los Angeles office of Milbank, Tweed, Hadley & McCloy.