

Trap for the Unwary: Section 2115 of the California Corporations Code

Section 2115 of the California Corporations Code requires corporations not incorporated in California but with a substantial presence in California (called a “quasi-California corporation”), to comply with specified provisions of the California Corporations Code. Some of these provisions of the California Corporations Code, however, conflict with the corporate statutes of the other states. As a result, corporations may be unable to determine which state law to apply to key areas of corporate governance.

On May 5, 2005, the Delaware Supreme Court, in *VantagePoint Venture Partners 1996 v. Examen, Inc.*, affirmed the “internal affairs doctrine,” ruling that Section 2115 violates the United States Constitution and that the internal corporate affairs of a Delaware corporation are governed solely by the General Corporation Law of the State of Delaware (the “DCGL”).

Examen, Inc., a privately held Delaware corporation with its principle place of business in California, entered into a merger agreement with a Delaware sub-

sidiary of Reed Elsevier Inc. VantagePoint Venture Partners, a Delaware limited partnership, owned 83% of Examen Inc.’s preferred stock. The DCGL permits a merger approved by a majority of all the outstanding shares of the Delaware corporation and does not require separate approvals by each class of stock. Section 1201(a) of the California Corporation Code, which is one of the provisions specified by Section 2115, requires the approval of each class of stock for a merger. Accordingly, if Section 1201(a) governed, VantagePoint Venture Partners would have significant leverage because it could block the merger in connection with a class vote by the preferred stock.

Section 2115

Section 2115 provides that, if more than one-half of a corporation’s outstanding voting securities are owned by persons having addresses in California and specified property, payroll and sales factor tests are satisfied then the corporation must comply with certain provisions of the California Corporations Code even if the corporation is incorpo-

rated in another state.¹ The following corporations are, however, exempt from Section 2115:

- ▶▶ corporations listed on the New York Stock Exchange or American Stock Exchange,
- ▶▶ corporations quoted on the NASDAQ National Market System, and
- ▶▶ wholly-owned subsidiaries of an otherwise exempt corporation.

If Section 2115 is deemed to apply to a non-California corporation, Section 2115 provides that the following aspects of the quasi-California corporation's internal affairs will be governed by California corporate law to the exclusion of the law of the state of incorporation:

- ▶▶ the annual election of directors;
- ▶▶ removal of directors without cause or by court proceedings;
- ▶▶ the filling of director vacancies where less than a majority in office are elected by shareholders;
- ▶▶ the director's standard of care;
- ▶▶ the liability of directors for unlawful distributions and of shareholders who receive unlawful distributions;
- ▶▶ indemnification of directors, officers and others;

- ▶▶ limitations on corporate distributions in cash or property;
- ▶▶ the requirement for annual shareholders' meetings and remedies for the same if not timely held;
- ▶▶ the shareholders' entitlement to cumulative voting;
- ▶▶ the conditions when a supermajority vote is required;
- ▶▶ limitations on the sale of assets, mergers, and conversions;
- ▶▶ the limitations and conditions for reorganization;
- ▶▶ dissenter's rights;
- ▶▶ records and reports;
- ▶▶ actions by the Attorney General; and
- ▶▶ inspection rights.

Delaware Supreme Court Ruling

VantagePoint filed suit in the California Superior Court seeking a declaration that it was entitled to a separate class vote based on Section 2115, but the California court stayed the California proceeding pending a ruling from the court in a concurrent Delaware proceeding. The Delaware Chancery Court ruled on March 29, 2005 that Delaware law, to the exclusion of California law, would apply to the shareholder vote requirement,

under the internal affairs doctrine. The Delaware Supreme Court affirmed the ruling of the Delaware Chancery Court. The Court relied on the internal affairs doctrine enunciated by the U.S. Supreme Court in *CTS Corp. v. Dynamics Corp of Am.*, explaining that the internal affairs doctrine is a long-standing choice of law principle that requires that only the law of the state of incorporation is to be applied to “those matters that pertain to the relationships among and between the corporation and its officers, directors and shareholders.”

The Delaware Supreme Court went on to state that:

- ▶▶ the internal affairs doctrine is mandated by constitutional principles under the Due Process Clause of the Fourteenth Amendment, except where the law of the state of incorporation is inconsistent with national policy on foreign or interstate commerce, and
- ▶▶ disputes concerning shareholders’ right to vote fall within the purview of the internal affairs doctrine, noting that VantagePoint had not cited any California Supreme Court decision that had applied Section 2115 to shareholder voting of a corporation not incorporated in California.

In the Court's analysis of Section 2115, it stated that the internal affairs doctrine is based on the need for uni-

formity, certainty, stability and predictability as this “protects the justified expectations of the parties with interests in the corporation.” The Court stated that Section 2115 was not certain or predictable, as the criteria for determining whether a corporation is subject to Section 2115 is always changing as the results of the various tests to determine whether a non-California corporation is a quasi-California corporation can vary from year to year. The Court also noted that the application of Section 2115 to a non-California corporation was “apt to produce inequalities, intolerable confusion, and uncertainty and intrude into the domain of other states that have a superior claim to regulate the same subject matter.”

The Delaware Supreme Court further stated that California courts would themselves recognize the constitutional imperatives of the internal affairs doctrine that the United States Supreme Court has since recognized and “apply Delaware law [to the internal affairs of a Delaware corporation], given the vitality and constitutional underpinnings of the internal affairs doctrine.”

Future of Section 2115

While the Delaware Supreme Court's opinion provides reassurance to Delaware corporations that Delaware courts will apply Delaware law to a Delaware corporation's internal corporate affairs, the uncertainty of whether other state courts will do so still

remains. While the Delaware Supreme Court did conclude that California's courts would also apply Delaware law to the facts of *VantagePoint v. Examen*, until a California court does so rule this, quasi-California corporations should take the possible continued vitality of Section 2115 into account in connection with their corporate governance and corporate transaction activities.

Endnotes

1. Property factor, payroll factor, and sales factor are defined in Sections 25129, 25132 and 25134 of the Revenue and Taxation Code as follows: (1) the property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year and the denominator of which is the average

value of all the taxpayer's real and tangible personal property owned or rented and used during the taxable year; (2) the payroll factor is a fraction, the numerator of which is the total amount paid in this state during the taxable year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year; and (3) the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Section 2115 applies if the average of the property factor, the payroll factor, and the sales factor of the corporation is more than 50 percent during its latest full income year.

For more information
please contact:

M. Ridgway Barker

Stamford
(203) 351-8032
mrbarker@kelleydrye.com

Randi-Jean G. Hedin

Stamford
(203) 351-8107
rhedin@kelleydrye.com