Cutting Down California's Long-Arm Statute

Law360, New York (July 11, 2012, 2:05 PM ET) -- A fixture of California corporate law for more than a quarter century, Section 2115 of the California Corporations Code imposes various requirements of California law on foreign corporations with substantial connections to the state.

The long-arm statute applies California law with regard to, among other things, the election and removal of directors, indemnification of directors and officers, stockholder voting requirements, stockholder distributions, and the rights of stockholders in mergers, to corporations incorporated in a different state, e.g., Delaware or Nevada.

This can often lead to conflict between the laws of the state of incorporation and California, and create the expense to corporations of lawyers hired to attempt to harmonize inconsistencies between the two sets of corporate laws. But two developments during the last month indicate that foreign corporations in California no longer having to answer to two separate masters.

California Corporations Code Section 2115 applies to corporations incorporated under the laws of another jurisdiction which have an average of 50 percent or more of their business in California — as measured by property, payroll and sales — or more than half of their outstanding voting shares held by California residents.

However, it exempts from its application foreign corporations which are listed on certain enumerated national stock exchanges, such as the New York Stock Exchange or the NASDAQ Global Market.

Section 2115 imposes upon the corporations to which it applies the requirement to follow numerous sections and chapters of the General Corporation Law of the California Corporations Code. These sections of California corporate law are in addition to the laws of the state of incorporation.

The provisions of California law imposed by Section 2115 are often contrary to the corporate laws of a foreign corporation’s home state. California law, for example, mandates cumulative voting for the election of directors.

Delaware law, in contrast, permits, but does not mandate, cumulative voting. Thus, a Delaware corporation, with a stockholder-approved charter prescribing simple majority voting for directors, would find itself subject to cumulative voting requirements should it meet the substantial connections test of Section 2115, notwithstanding the fact that Delaware corporate law permits the corporation to not have cumulative voting if it so chooses.

Such inconsistencies, when aggregated across the various impositions of Section 2115, increase the cost, complexity and risk of doing business in California.

Courts in other states have considered the requirements of Section 2115 to be an impermissible intrusion upon their jurisdictional power over the corporations which they charter.

In the most significant case to address the validity of Section 2115's long-arm reach into the affairs of a corporation chartered by another state, VantagePoint Venture Partners 1996 v. Examen Inc., 871. A.2d 1108 (2005), the Delaware Supreme Court considered whether a Delaware corporation with substantial connections to California was required to seek the consent of each outstanding series of its stock to approve a merger, as per California law applied through Section 2115, or whether the corporation could rely on Delaware law and its own charter and seek only the consent of all outstanding shares.

Approval of a merger depended upon the outcome of the determination of which state's law applied because a majority of stockholders favored the merger, but the majority of one series opposed the merger, which meant that the merger would not be approved if California law governed and the merger would be approved if Delaware law did apply.

Perhaps unsurprisingly for a Delaware court adjudicating a question of Delaware corporate law for a Delaware corporation, the Delaware Supreme Court found that California could not constitutionally impose its laws on the internal affairs of an entity not incorporated in California, regardless of the requirements of Section 2115.

Rather, the Delaware Supreme Court ruled in VantagePoint, the internal affairs of a corporation incorporated in Delaware must be governed by the Delaware General Corporation Law, and not the laws of another state, and allowed the merger at issue to proceed.

Since the decision in VantagePoint, there has been missing an acknowledgement by a California authority that Section 2115 goes too far in its imposition of California corporate law upon foreign corporations. That is, however, until late last month, when the Second District of the California Court of Appeal, in a published portion of an opinion filed on May 23, 2012, signaled, in dicta, that matters of internal corporate governance, including the voting rights of stockholders, the payments of dividends and the procedural requirements of stockholder derivative suits, fall within a corporation's internal affairs, and that only one state's laws — specifically, the state of incorporation — should govern such internal affairs.

In the California case at appeal, Lidlow v. International Rectifier Corp., the California court determined that California law should apply in a suit for wrongful termination of the chief executive officer of a Delaware corporation in violation of the public policy of California.

In so doing, although the California Court of Appeal upheld the application of California law over the law of Delaware on an issue concerning the internal affairs of a Delaware corporation — the firing of the CEO — it came to the conclusion that this was a permissible departure from the internal affairs doctrine as enunciated by the Delaware Supreme Court in Vantage Point.

In fact, the California court agreed with the analysis of the Delaware Supreme Court in VantagePoint. Specifically distinguishing from the issues of public policy implicated by the firing, in California, of the CEO of International Rectifier, the California Court of Appeal agreed that the voting rights of stockholders, the procedural requirements of stockholder derivative suits and the payment of dividends to stockholders "involve matters of internal corporate governance and thus, fall within a corporation's internal affairs."

While Section 2115 would otherwise directly impose California law for such matters, the California Court of Appeal stated its belief, in concurrence with VantagePoint, that Delaware law only should apply to these issues concerning a corporation's internal affairs. By throwing its tacit approval to the VantagePoint decision, the California court likely signaled an unwillingness to enforce Section 2115.

Section 2115 also faces an attack on the legislative front as the California Legislature has taken up the initiative to repeal the whole of Section 2115. In doing so, the costs of maintaining Section 2115, both in enforcement and to the corporations it regulates, have been emphasized as justifications for why it should be repealed.

On May 7, 2012, the California Assembly passed Assembly Bill 2260 by a floor vote of 75 to 0. According to the legislative counsel's analysis for the floor vote, "AB 2260 takes the proactive step of repealing Section 2115 before the federal courts strike it down and the state is forced to spend additional taxpayer dollars defending a regulation that keeps companies out of California." The bill currently awaits the review of the Judiciary Committee of the California State Senate.

With both the legislature and the judiciary challenging Section 2115, it may not be long before California's corporate long-arm statute is down for the count, and foreign corporations doing business in California will have the comfort of being able to look at a single body of law — the law of its state of incorporation — for the governance of their internal affairs.

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