M&A NOTES

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Delaware Supreme Court Holds California Corporate Long-Arm Statute Violates Internal Affairs Doctrine

In May 2005, the Delaware Supreme Court in *VantagePoint Venture Partners 1996 v. Examen, Inc.*[1] held that Delaware law, not California law, applied when determining the required vote for a merger involving a Delaware corporation having significant ties to California. While this case has not completely settled the applicability of California's corporate long-arm statute to privately-held corporations organized outside of California, it is clear that venture capitalists, private equity funds and other investors should (i) carefully consider the jurisdiction of incorporation of the companies in which they invest and (ii) negotiate to include in a corporation's charter documents any investor protections they desire.

Background

In early March 2005, Examen, Inc., a Delaware corporation, filed a complaint in the Delaware Court of Chancery against VantagePoint Venture Partners, Inc., a venture capital firm holding 83% of Examen's preferred stock. Examen sought declaratory relief that Delaware corporate law and the provisions of its preferred stock certificate of designation applied when determining the required vote on the proposed merger involving Examen. If Delaware law applied, then Examen's certificate of designation would govern, thereby allowing the merger to go forward if approved by the holders of a majority of common stock and preferred stock *voting together as one class*.

Days later, VantagePoint filed an action in the California Superior Court seeking a determination of whether Examen was a "quasi-California" corporation under California Corporations Code Section 2115 and, if so, seeking a ruling that California law governed the merger. If California law applied, then the merger could only go forward if approved by the holders of a majority of common stock and the holders of a majority of preferred stock *voting separately as two classes*, essentially providing VantagePoint with veto power over the merger. In late March, the California Superior Court stayed its action pending the ruling of the Chancery Court.[2]

California's Corporate Long-Arm Statute and "Quasi-California" Corporations

Section 2115 of the California Corporations Code purports to apply to privately-held corporations that have significant ties to California but are incorporated elsewhere.[3] If a majority of a foreign corporation's outstanding voting securities are held of record by persons having addresses in California and if property, payroll and sales factors tests set forth in the California Revenue and Taxation Code are met, then California applies several sweeping provisions of its corporate law "to the exclusion" of the law of the jurisdiction where the foreign corporation is incorporated.[4] If Section 2115 applies, then California law attempts to control a long list of corporate actions, including, among other things, the election and removal of directors, the indemnification of directors, directors' standards of care, limitations on dividends, cumulative voting by stockholders and the requirements relating to asset sales, mergers, conversions and reorganizations. Thus, under California law, the organizational documents of a foreign corporation meeting the tests to be considered a "quasi-California corporation" are deemed amended in order to comply with California law.

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1 871 A.2d 1108 (2005).

2 Examen has requested a hearing on a demurrer in the case which is currently scheduled to be argued in California Superior Court on June 14. No papers have yet been filed by either party relating to the demurrer.

3 Section 2115 does not apply to any corporation (1) with outstanding securities listed on the New York Stock Exchange or the American Stock Exchange, or (2) with outstanding securities designated as qualifiied for trading on the Nasdaq National Market, or (3) if all of its voting shares are owned directly or indirectly by a corpora tion or corporations not subject to Section 2115.

4 Section 2115(b) of the California Corporations Code.

Delaware Court of Chancery and Delaware Supreme Court Rulings

In late March, the Court of Chancery ruled that the case was governed by the internal affairs doctrine, a long-standing choice of law principle, and, in applying that doctrine, the court held that Delaware law governed the vote that was required to approve the merger.[5] VantagePoint had argued that Section 2115 did not conflict with Delaware law, and instead, operated to provide additional requirements that must be met to protect investors. The Court of Chancery noted that Section 2115 "expressly states that it operates 'to the exclusion of the law of the jurisdiction in which [the company] is incorporated.'"[6] The Court of Chancery concluded that it could not enforce both Delaware and California law. In upholding the lower court's ruling, the Delaware Supreme Court also applied the internal affairs doctrine, together with the constitutional principles of the due process and commerce clauses, to hold that only one state should have the authority to regulate a corporation's internal affairs -- the state of incorporation. "The internal affairs doctrine applies to those matters that pertain to the relationships among or between the corporation and its officers, directors and shareholders. . . Accordingly, the conflicts practice of both state and federal courts has consistently been to apply the law of the state of incorporation to 'the entire gamut of internal corporate affairs.'"[7]

Conclusion and Practice Tips

California's corporate long-arm statute purports to offer investor protections to stockholders of privately-held "quasi-California" corporations. What is clear from the Delaware Supreme Court's ruling is that a Delaware court would not enforce against a Delaware corporation any of the provisions of California Corporations Code that purport to govern the internal affairs of a Delaware corporation. While practitioners may be hoping that this case has finally put to rest whether several key sections of the California Corporations Code apply to corporations having significant ties to California but incorporated elsewhere, a case in California based on the same facts and brought by the losing party in the Delaware case has not yet been dismissed. Until a California court takes a position consistent with the Delaware courts or until the U.S. Supreme Court makes a ruling on the applicability of the California Corporations Code to "quasi-California" corporations, there remains some uncertainty as to whether the corporate laws of California or the corporate laws of the incorporating jurisdiction govern the internal affairs of a corporation organized outside of California but having significant ties to California. At a minimum, any investor in any corporation should carefully consider the jurisdiction of incorporation of the corporation in which it invests. And, an investor in a privately-held "quasi-California" corporation should negotiate for provisions in the corporation's charter that provide the investor with the protections it desires instead of relying on the California Corporations Code for any investor-favorable provisions.

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5 *Examen, Inc. v. VantagePoint Venture Partners 1996*, not reported in A.2d, 2005 WL 790812 (Del. Ch., Mar. 31, 2005).

6 *Id*. at *3.

7 *Id.* at *4, citing *McDermott Inc. v. Lewis,* 531 A.2d 206, 216 (Del. 1987).

Should you have any questions about the matters addressed in this issue of *M&A Notes*, please contact the following Kirkland & Ellis author or the Kirkland & Ellis partner you normally contact.

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