Client Alert

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Pillsbury Winthrop Shaw Pittman LLP

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Internal Affairs Doctrine Trumps California's Quasi-California Corporation Statute

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Pillsbury Winthrop Shaw Pittman lawyers secure landmark decision from Delaware Supreme Court. In *VantagePoint Venture Partners 1996 v. Examen, Inc.,* 871 A.2d 1108 (Del. May 5, 2005), Delaware's highest court ruled that the internal affairs doctrine trumped California's so-called Quasi-California Corporation Statute (California Corporations Code § 2115). The Court held that choice of law principles and the federal constitution mandated that VantagePoint's right to vote on Examen's merger be determined under the law of Delaware, where Examen was incorporated, rather than under the law of California.

Lawyers from Pillsbury Winthrop Shaw Pittman, along with lawyers from Morris, Nichols, Arsht & Tunnell, on behalf of Examen, persuaded the Delaware Chancery Court and then the Delaware Supreme Court that VantagePoint, the holder of 83% of Examen's preferred stock, was not entitled to a vote by class on Examen's proposed merger with a subsidiary of Reed Elsevier. The courts rejected VantagePoint's argument that Section 2115 gave it a right to a "class vote," which would have permitted it to block the merger. Non-California corporations meeting the criteria of Section 2115 are, by its terms, subjected to a host of California Corporations Code sections on a variety of issues "to the exclusion of the law of the jurisdiction in which [the corporation] is incorporated"—law that would otherwise govern those issues. The statute applies if (a) more than one-half of the corporation's outstanding voting securities are held of record by persons having addresses in California and (b) the average of the corporation's "property factor," "payroll factor" and "sales factor"(as defined in Sections 25129, 25132, and 25134 of the California Revenue and Taxation Code) is more than 50 percent during the corporation's latest full income year. The property factor is the ratio of the corporation's California real and tangible personal property to all of its real and tangible personal property worldwide. Similarly, the payroll factor is the ratio of the corporation's California payroll to its worldwide payroll, and the sales factor is the ratio of the corporation's California sales to its worldwide sales. The statute looks at the average of these three factors, after making a series of complicated adjustments reflecting California's "unitary" system of taxing corporations.

Background

Examen was a Delaware corporation, engaged in the business of providing web-based legal expense management services to customers throughout the United States. VantagePoint Venture Partners 1996 is a Delaware limited partnership that purchased preferred stock in Examen. In 2004, Examen began negotiating to merge Examen into a wholly-owned subsidiary of Reed Elsevier, Inc. Before the merger, VantagePoint owned approximately 83% of Examen's preferred stock but no common stock. VantagePoint's preferred stock represented approximately 13% of Examen's total voting stock on an as-converted basis.

Examen's corporate documents (and Delaware law) provided that any merger had to be approved by a majority in interest of all stockholders voting as a single class. But VantagePoint argued that provisions of the California Corporations Code (made applicable through Section 2115) required that the merger be approved by each class of Examen's capital stock, voting separately (a so-called "class vote"). VantagePoint's argument, if accepted, would have given VantagePoint, as holder of 83% of Examen's preferred stock, veto power over the merger.

Lawyers from Pillsbury and Morris Nichols responded by filing suit on March 3, 2005 in Delaware Chancery Court on behalf of Examen, seeking declaratory relief that Delaware law and the internal affairs doctrine governed shareholder voting rights in the merger and not Section 2115 and its associated provisions. VantagePoint responded five days later by filing its own declaratory relief action in California asking the court to declare that Section 2115 should govern (assuming Examen met Section 2115's criteria). The California court stayed VantagePoint's California action pending the outcome of the Delaware action.

The Delaware Courts' Decisions

On March 31, 2005, the Delaware Chancery Court granted Examen's motion for judgment on the pleadings, determining that the internal affairs doctrine does apply and that VantagePoint was not entitled to class voting rights under Section 2115. *Examen, Inc. v. VantagePoint Venture Partners 1996,* ___ A.2d ___, 2005 WL 1048796 (Del. Ch. Mar. 31, 2005). The Chancery Court rejected VantagePoint's argument that the California statute does not conflict with Delaware law, observing that Section 2115 "expressly states that it operates 'to the exclusion of the law of the jurisdiction in which [the company] is incorporated.'" The Court held that the issue of VantagePoint's voting rights implicated the relationship between a corporation and its stockholders—a relationship governed by the internal affairs doctrine. The Chancery Court concluded that it could not enforce both Delaware law and California law and therefore, applying a choice-of-law analysis, chose Delaware law. The Chancery Court did not address the constitutionality of Section 2115.

VantagePoint appealed the ruling and sought to enjoin the merger pending the appeal. On April 5, the Delaware Supreme Court denied an injunction but granted an expedited appeal. The same day the merger closed. Examen is now LexisNexis Examen Inc.

A month later, on May 5, the Delaware Supreme Court affirmed the Chancery Court's ruling. Applying United State Supreme Court precedent (*CTS Corp v. Dynamics Corp of America,* 481 U.S. 69 (1987)) and Delaware Supreme Court precedent (*McDermott Inc. v. Lewis,* 531 A.2d 206 (Del. 1987)), the Court stated: "By providing certainty and predictability, the internal affairs doctrine protects the justified expectations of the parties with interests in the corporation." Noting that the factors triggering the application of Section 2115—where shareholders live, money is made and property and employees are located—can vary from year to year, the Court said that allowing such variables to determine which of two

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conflicting state laws governs “completely contravenes the importance of stability within inter-corporate relationships that the United States Supreme Court recognized in *CTS*.” [*CTS*, coincidentally, is a case that Pillsbury lawyers argued and won in the United States Supreme Court.]

The Delaware Supreme Court then went beyond the Chancery Court’s opinion, noting that the internal affairs doctrine is not merely a conflicts of law principle, but rather has constitutional underpinnings. Under the Commerce Clause, the Court noted, a state has no interest in regulating the internal affairs of a foreign corporation. Rather, application of the internal affairs doctrine is mandated by constitutional principles, except in the rarest situations.

Finally, the Delaware Supreme Court rejected VantagePoint’s reliance on *Wilson v. Louisiana-Pacific Resources, Inc.,* 138 Cal. App 3d 216 (1982), the only California court to rule on the constitutionality of Section 2115. The Delaware Supreme Court noted that *Wilson* was decided before *CTS* and *McDermott*, and its validity had been questioned by another California decision rendered after *CTS* and *McDermott*. These and other later cases, the Court said, have “recognized the constitutional imperatives of the internal affairs doctrine.”

Commentary

The ruling is significant for Delaware corporations and potentially for other non-California corporations that conduct business in California. Through Section 2115, qualifying “quasi-California” corporations might be subject to myriad substantive provisions of California’s General Corporation Law. Under the holding of the Delaware Supreme Court, however, matters involving the internal affairs of a “quasi-California” corporation must be governed by the law of the state of incorporation, notwithstanding Section 2115.

For further information on this issue, please contact the Pillsbury Winthrop Shaw Pittman LLP partners who handled the case on behalf of Examen:

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