Application of the Internal Affairs Doctrine in California

By Gerald Niesar and June Lin

Introduction

Imagine the Board of Directors of a Delaware corporation holds a shareholders' meeting in San Francisco, California (where most of the shareholders reside) and decides to waive cumulative voting for the meeting. This is allowed under the Delaware General Corporation Law. One shareholder in San Francisco shows up at the meeting and protests the waiving of cumulative voting, and insists on his right to cumulative voting. This is not permitted under Delaware corporate law, and therefore no court would uphold the shareholder's right to cumulative voting, right? Wrong! (at least if the court is a California court)

The internal affairs doctrine is a long-standing choice of law principle which recognizes that only one state, the state of formation, should have the authority to regulate the internal affairs of a corporation or limited liability company (LLC) (i.e. matters relating to the relationships between the corporation and its officers, directors, and shareholders or the LLC and its managers and members). Without the internal affairs doctrine, the entity and its members or shareholders could be faced with conflicting demands and rules arising under two or more different states' laws. Recently there have been a number of cases exhibiting the tension between California's paternalistic attitude regarding shareholder and LLC member rights and the internal affairs doctrine. The issue arises in those situations where a corporation or LLC is formed under the laws of another state (referred to herein as a "foreign LLC or corporation"), but a significant percentage of the owners, business and employees are located in California. Other than differences in the specific statutory treatment, the issue in the LLC context is governed by the same principles that would apply in a corporate context.

Internal Affairs Doctrine in the Corporate Context

Most of the case law regarding the internal affairs doctrine has arisen in the corporate context. The General Corporation Law of California contains several clauses relevant to the internal affairs doctrine for corporations. Section 2116 provides that the liability, if any, of directors of a foreign corporation for making unauthorized dividends, purchase of shares or distribution of assets, false certificates, reports or public notices, or "other violations of official duty," will be determined according to the laws of the state of incorporation. However, Section 2115 provides that a foreign corporation will be governed by California law for almost all internal affairs issues if a majority of the shareholders have addresses in California, and the average of the property, payroll and sales factors, as defined in the Revenue and Taxation Code, is more than fifty percent during its latest full income year. Note that Section 2115 applies to the directors' standard of care, annual election of directors, and directors' liability for unlawful distributions, all of which provisions seem in direct contradiction to Section 2116. Note also that Section 2115 does not apply if the foreign corporation's stock is listed on a major exchange.

California courts have looked at Section 2115's enforceability at least twice and in neither case has the Court questioned the effectiveness of the law, notwithstanding constitutional law challenges. In *Havlicek v. Coast-to-Coast Analytical Services, Inc.*[1], the Court acknowledged that the requirements of Section 2115 were not met, but still held that the California law on directors' inspection rights found in Corp. Code Section 1602 would apply to a Delaware corporation by virtue of a "long arm" provision: "This section applies to a director of any foreign corporation having its principal executive office in this state or customarily holding meetings of its board in this state." Thus, Section 1602 inspection rights would apply even to

[1] 39 Cal. App. 4th 1844 (1995).

New York Stock Exchange listed companies, representing another significant override of the internal affairs doctrine.

Wilson v. Louisiana – Pacific Resources, Inc.[2] squarely dealt with the Section 2115 constitutionality issue as a question of first impression. Specifically, the question was whether the cumulative voting requirements of California law could apply to a Utah corporation, whose shareholders and property, payroll and sales factors were within the Section 2115 standards, without violating the U.S. Constitution. The Court addressed the U.S. Constitution's full faith and credit clause, commerce clause, contract clause, and due process and equal protection clauses, finding no reason to believe enforcing Section 2115 would violate any of them.

Not surprisingly, the first reported Delaware court opinion to address Section 2115's enforceability easily found the Section inconsistent with the U.S. Constitution. In *Vantagepoint Venture Partners 1996 v. Examen, Inc.*[3], the Delaware Supreme Court held that Delaware, not California, law governed the vote required to approve the merger between two Delaware corporate entities, in spite of Section 2115. It is interesting to note that the complaining preferred shareholder lost the race to the court, as its action was filed in California Superior Court five days after the Delaware action was commenced by Examen, Inc. Apparently for this reason, the California Court stayed its action pending the resolution of the Delaware case. It is also interesting to speculate how the California Court would have ruled had the first action been filed in California. The Delaware Supreme Court noted that, after *Wilson v. Louisiana – Pacific* was decided in 1982, the U.S. Supreme Court issued a very strong opinion upholding the internal affairs doctrine, *CTS Corp. v. Dynamics Corp. of America* [4]. Moreover, the *Vantagepoint* Court noted that the California Second District Court of Appeals recently questioned the validity of the

[2] 138 Cal. App. 3d 216 (1982).
[3] 871 A.2d 1108 (2005).
[4] 481 U.S. 69 (1987).

Wilson v. Louisiana – Pacific holding in *State Farm Mutual Automobile Insurance Co. v. The Superior Court of Los Angeles County* [5].

Perhaps the Delaware Supreme Court's guess as to how the California courts would rule was overly optimistic. Shortly after the *Vantagepoint* case, the California Fourth District Court of Appeal issued its opinion in *Friese v. The Superior Court of San Diego County* [6]. Friese, the Bankruptcy Trustee of the estate of Peregrine Systems, Inc., brought an action in California State Court to recover alleged insider trading profits realized by certain former officers, directors and control persons of Peregrine. The issue was that Peregrine was a Delaware corporation, and the Trustee was suing under California's insider trading statutes, Corp. Code Section 25402 and, more importantly, Section 25502.5 which allows a treble damages recovery in the event of insider trading violations. In the District Court, the defendants were granted a demurrer on the grounds that California's internal affairs statute (Corp. Code 2116) would refer the matter to Delaware law because the Trustee was seeking a recovery from insiders, specifically directors, for the benefit of the corporation. The defendants argued that the action to recover for insider profiting was "no more than a breach of fiduciary duty action" which should be subject to 2116's referral to Delaware law. The Appellate Court overruled, holding that Sections 25502.5 and 25402 are securities laws, designed to create confidence in the securities markets, not just provide a remedy for recovery by the corporation (shareholders) for the misdeeds of those in control of the corporation. So, once again, we see a California Appellate Court finding a way around the internal affairs doctrine, even when, as in this case, the specific issue of director liability is in the statute.

[5] 114 Cal. App. 4th 434 (2003).
[6] 134 Cal. App. 4th 693 (2005).

One should also question the *Vantagepoint* Court's reliance on *State Farm Mutual Automobile Insurance Co.* as an indication that the California courts will reject Section 2115 in favor of the internal affairs doctrine. State Farm Mutual Automobile Insurance Co. is a mutual insurance corporation formed under Illinois law. The policy holders in such a corporation are also its "shareholders." Five million of State Farm's fifty million policy holders lived in California. Some of the California policy holders sued the State Farm Board of Directors, claiming that the Board should have declared dividends. The Court noted that a California court could apply local law to a foreign corporation that has sufficient contacts with California, such as conducting business or having an office in California. The Court drew specific attention to Section 2115: "And, as codified in the Corporation's Code, California law governs certain internal affairs of a foreign corporation [describing the Section 2115 criteria]. In those circumstances, California law even regulates the dividends of a foreign corporation to some extent. But the State Farm policyholders do not contend that [Section 2115 applies] to State Farm." Indeed, they could not, as only ten percent of the State Farm shareholders had addresses in California, far short of Section 2115's requirement of fifty percent. Thus, it would appear more correct to describe the State Farm opinion as supporting the notion that Section 2115 will override the internal affairs doctrine, although clearly the issue was not presented in the case.

Internal Affairs Doctrine in the LLC Context

For LLCs in California the internal affairs doctrine is codified in Corp. Code Section 17450: "The laws of the state or foreign country under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members." However, Section 17450 is partially reversed by Section 17453: "If the members of a foreign limited liability company residing in this state represent 25 percent or more of the voting interests of members of that limited liability company, those members shall be entitled to all information and inspection rights provided in Section 17106."

Perhaps the most persuasive argument to allow California law to override the internal affairs doctrine can be made where all of the members of a foreign LLC are California residents. This was the factual setting in *Burkle v. Burkle* [7]. The *Burkle* case provides an interpretation of the 25% California member threshold requirement in Section 17453. Carrie Burkle, a California resident, owned a 1% interest in a Delaware LLC, the other 99% being owned by her father Ronald Burkle. Carrie asserted inspection rights under Section 17453, but Ronald, also a California resident, asserted that the statute gave inspection rights only to "those members" who represent 25% or more of the ownership interests. The Appellate Court held that the phrase "those members" in Section 17543 refers to any and all members who are California residents. Thus, even a 1% member would have Section 17106 inspection rights if at least 25% of all interests were held by California members. It does not appear that Ronald argued that Section 17453 is invalid as contrary to the internal affairs doctrine, or unenforceable as a violation of the full faith and credit clause or any other clause of the U.S. Constitution.

Moving from the "all California" case to the other extreme one encounters an unpublished, therefore uncitable, case *Gene Z. Salkind, Trustee v. Mariana Danilovic and Digital Media X* [8]. This was an appeal from the Superior Court of Los Angeles County. The plaintiff, Salkind as Trustee, was a practicing neurosurgeon from Philadelphia, Pennsylvania who subscribed for a $50,000 convertible preferred interest in a Delaware LLC (Digital Media). His subscription agreement stated that if by June 28, 2000, the LLC had not received a total of $1,000,000 in subscriptions, Salkind could demand his money back. The threshold funding was

[7] 141 Cal. App. 4th 1029 (2006).
[8] 2005 Cal. App. Unpub. Lexis 4737 (2005).

not received in time, Salkind demanded the return of his money but did not receive it, and Salkind sued, for some reason in Los Angeles. There is no indication in the Court's opinion as to the principal place of business of the LLC, nor the residence of the individual defendant, Danilovic, who was on the Board of Directors that managed the LLC, nor whether any of the members of the LLC were California residents. Various causes of action were asserted, but the Appellate Court determined that the only one worth considering was the alleged breach of fiduciary duty. The Court said that by accepting the subscription funds Danilovic, as a member of the Board of Directors that managed the LLC, became subject to a fiduciary duty to Salkind. The Court noted in a list of "issues" that the defendant claimed "the limited liability act of Delaware applies." In the discussion portion of the opinion the Court never mentions Delaware law. To the contrary, it immediately jumps to citations of California case law on fiduciary duties, and states that Corp. Code Section 17153 "establishes the existence of Danilov's fiduciary duty" to the members, following this statement with more citations to California cases. There is no indication that the Court considered the fact that the LLC was a Delaware entity was even relevant to the legal issues presented.

Because *Salkind v. Danilovic* cannot be cited as precedence, it is most interesting as an example of how California courts may derail a business structure finely crafted by attorneys to avoid the most paternalistic provisions of California's LLC Act. Having noted that the "issue" of entity domicile was presented, and then proffering no rationale for why Delaware law was not applied, the Court appears to be signaling that the internal affairs doctrine is essentially not applicable to a case before a California court, even where there is no demonstration of any other connection to California.

Relying on the internal affairs doctrine, parties in California often choose to form their LLCs under Delaware law to allow members and managers to waive their fiduciary duties to one another (California's LLC Act appears to prohibit members and managers from entirely eliminating their fiduciary duties to one another, whereas Delaware law allows members to agree in their Operating Agreement that they shall have no fiduciary duties to one another). However, Section 17453 and cases like *Salkind v. Danilovic* cast doubt on the enforceability of such a waiver of fiduciary duty by members and managers of a Delaware LLC. Furthermore, the California Second District Court of Appeal Court in *Walter J. Neubauer v. Andrew Goldfarb* [9] held that a breach of fiduciary duty constitutes a "willful injury to the…property of another" and is therefore an intentional tort, and such intentional torts may not be waived prospectively by contract under California Civil Code Section 1668. Although the *Neubauer* case deals with fiduciary duties of managers and controlling persons of a corporation, it would support the proposition that a California court could not enforce a provision that purports to entirely eliminate the fiduciary duties of a manager of an LLC. Consequently, if a Delaware LLC has all California members, and no connection to Delaware, the members are unlikely to be able to avoid their fiduciary duties simply by forming in Delaware. Even if not all members of the Delaware LLC are California residents, if there is at least one California investor in the Delaware LLC who is the victim of a breach of fiduciary duty by the LLC's manager, as a California plaintiff in an intentional tort suit it is likely that such California investor could sue the manager for breach of fiduciary duty, even if the manager purportedly waived its fiduciary duties in an Operating Agreement that provides it is governed by Delaware law.

Conclusion

[9] 108 Cal. App. 4^{th} 47 (2003).

The current state of the law may be summarized as follows: parties wanting the protection of the California laws should rush to a California court, while the opposing side should find some excuse to initiate a defensive action in the courts of the State under whose laws the entity was formed, especially if that State is Delaware. In this regard the action of the Delaware plaintiff in the *Vantagepoint* case is illuminating. There the plaintiff, presumably having gotten wind of the defendants' plan to assert class voting rights pursuant to California's Section 2115, filed a declaratory relief action in Delaware speculating that the defendant would assert such rights and asking the Delaware court to say what would happen if the defendant did indeed file such an action. Of course, this does not always work - it is difficult to conceive of what action father Burkle may have initiated in Delaware to stop his daughter from initiating her action in California.

This article is intended to provide a general summary and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. Gerald Niesar and June Lin are attorneys at Niesar & Vestal LLP in San Francisco, a law firm specializing in business law and corporate finance.