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Delaware Court Applies Internal Affairs Doctrine to Override California Law

On March 31, 2005, the Delaware Court of Chancery ruled that VantagePoint Venture Partners could not look to the California Corporations Code ("CCC") to force a separate class vote of preferred stockholders on the merger of Examen, Inc., a Delaware corporation in which VantagePoint owned a majority of the preferred stock, and Reed Elsevier, Inc.[1] The Delaware court rejected VantagePoint's argument that section 2115 of the CCC could provide greater voting rights than it had negotiated for or was otherwise entitled to under Delaware law. The outcome of this case highlights (i) the need for venture capital and other private equity firms to carefully consider the jurisdiction of organization of the companies in which they invest and (ii) the care that should be taken in drafting corporate charters and preferred stock instruments.

This case involved the choice of law governing the relationship between a corporation and its stockholders. Under Delaware corporate law, unless a corporation's charter otherwise provides, holders of all voting stock vote together as a single class to approve a merger. Thus, if Delaware law applied, VantagePoint would likely have been unable to block the proposed merger. Under California corporate law, regardless of the provisions in the charter, each class of capital stock votes separately on a merger. Thus, if California law applied, VantagePoint would effectively have a veto over the merger.

Interestingly, the ability to eliminate a class vote for holders of common stock is a reason venture capital firms often insist that their portfolio companies incorporate in Delaware, not California. To protect themselves, those firms generally bargain for a separate class veto to be contained in the instrument governing the preferred stock in which they invest. In this case, however, for reasons the court did not address, VantagePoint had not obtained a separate class vote. It was therefore in its best interest to argue for application of California corporate law in this instance.

Section 2115 Overview

The general rule, known as the "internal affairs doctrine," is that the relationship between a corporation and its stockholders is governed by the law of the jurisdiction of incorporation even if the corporation has no other contact with that jurisdiction.[2]

Subject to certain exceptions, section 2115 of the CCC provides that if (i) more than 50% of a foreign corporation's outstanding voting securities are owned by holders with California addresses and (ii) the corporation conducts a certain amount of its business in California (determined by mathematical factors based on property, payroll and sales) then, with respect to a laundry list of items, California corporate law supersedes the corporate law of the jurisdiction of incorporation.

Thus, for a Delaware corporation meeting the requirements of a "quasi-California corporation," California law purports to supersede Delaware law with respect to (among other things):

- the annual election of directors,
- a director's standard of care,
- the liability of directors and shareholders for unlawful distributions and
- class votes with respect to the approval of mergers.

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[1] *Examen, Inc. v. VantagePoint Venture Partners 1996*, Not Reported in A.2d, 2005 WL 790812 (Del. Ch., Mar. 31, 2005) (NO. CIV.A. 1142-N).

[2] 2 Harold Marsh, Jr. Et al., *Marsh's California Corporation Law* § 26.04, at 26-61 (4th ed. Supp. 2005-1).

Constitutional challenges to section 2115, which have arisen predominantly in California's lower courts, have not been successful.

VantagePoint and Examen

Examen is a privately owned corporation headquartered in California, with regional offices in California, Connecticut, Illinois, Massachusetts and Texas. VantagePoint is a large, sophisticated venture capital firm that owned 83% of the preferred stock (but no common stock) of Examen. When Examen entered into a merger agreement with Reed Elsevier and began preparing for a stockholder vote, VantagePoint asserted that it was entitled to a separate class vote under section 2115 of the CCC. Examen filed suit in the Delaware Court of Chancery seeking a declaration that California law does not apply to the voting rights of its stockholders. Examen argued that a stockholder vote is governed by the internal affairs doctrine.

In response to Examen's complaint, VantagePoint filed an action in California Superior Court requesting discovery to determine if Examen is subject to section 2115. VantagePoint argued that if it could show that Examen is covered by section 2115, the two classes of stock would vote separately on the merger, effectively giving VantagePoint a veto. The California court stayed VantagePoint's action until the Delaware court ruled.

The Delaware court did not address whether Examen was a quasi-California corporation under section 2115. Its opinion implied, but did not explicitly state, that such an analysis was irrelevant because of the internal affairs doctrine.

Holding that the internal affairs doctrine was still valid (based on United States Supreme Court[3] and Delaware[4] precedent), the court ruled that California law, including section 2115, was inapplicable. The court found that, under Examen's charter and Delaware law, all of the stockholders of Examen should vote together as a single class.

The court wrote that its decision was "not inconsistent with California law" and noted that VantagePoint failed to cite a single California Supreme Court case that applied section 2115 to the stockholder voting rights of a foreign corporation. Additionally, the court cited the 1993 *Draper* case, in which the Delaware Supreme Court observed that "[t]he California cases do not reveal a clear doctrine … that California will, in a case like the instant case, ignore the internal affairs doctrine and apply California law, not Delaware law."[5]

Implications

It appears from recent decisions that Delaware courts will continue to apply the internal affairs doctrine to claims based on section 2115 of the CCC. Of course, such rulings appear to conflict with the language of section 2115 that is meant to govern, in specified circumstances, the internal affairs of foreign corporations.

It is unclear how California courts would rule in a similar situation. No California court has yet opined on the applicability of section 2115 to class voting on mergers. One prominent treatise on California law notes that "[w]hile there is one California Supreme Court case that refers to [the internal affairs] doctrine with approval, most California cases have given it short shrift, and in fact it has largely fallen out of favor."[6] Nevertheless, the California cases are contradictory and have primarily dealt with constitutional issues outside the scope of this Alert.

Until California courts rule consistently one way or another on the different elements of section 2115 or the statute itself is declared unconstitutional, the most predictable decisions will come from Delaware courts.

In any case, venture capital and other private equity funds would be wise to ensure that their rights are clearly spelled out in advance in the corporate charter and preferred stock instrument. In this regard, the court in *Examen* was quick to note that VantagePoint was a sophisticated investor, and reasoned that if VantagePoint wanted a class vote on mergers it could (and should) have bargained for that right.[7]

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[3] *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987).

[4] See, e.g. *Draper v. Gardner Defined Plan Trust*, 625 A.2d 859, 867 n.10 (Del. 1993) ("When this Court considered [the internal affairs doctrine] issue six years ago in *McDermott*, it concluded that 'the umbilical tie of the foreign corporation to the state of its charter is still religiously regarded as conclusive in determining the law to be applied … in intracorporate disputes.'") (quoting *McDermott*, 531 A.2d at 215-16); *In re Oracle Corp. Derivative Litig.*, 808 A.2d 1206, 1213 n.21 (Del. Ch. 2002) ("Under the internal affairs doctrine, the law of the state of incorporation (Delaware) would apply to matter[s] of substantive law raised in the Delaware and California state court proceedings."); *Tera Sys., Inc. v. Mentor Graphics Corp.*, 2003 WL 23341841, at *1 (Del. Ch. Aug. 22, 2003) ("California law, including but not limited to Section 2115 of the California Corporations Code, does not govern or apply to any determination of the voting rights of the holders of Tera's Series A Preferred Stock in regard to the merger between Tera and TSI.").

[5] *Draper*, 625 A. 2d at 867 n.10.

[6] 2 Marsh, Jr., *supra* note 2, at 26-63.

[7] In fact, VantagePoint had bargained for a class right in the election of a director to Examen's board

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