The Pseudo-Foreign Corporation in California

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THE PSEUDO-FOREIGN CORPORATION
IN CALIFORNIA

As is all too apparent to state legislators across the nation, Delaware has controlled both the pace and direction of statutory corporate law in the twentieth century. Delaware's position in corporate law stems largely from the fact that Delaware law is considered more favorable to management than the law of any other state.1 Thus, to prevent corporations from deserting to the healthful climes of Delaware law, state legislators have been forced to relax local laws regulating internal corporate affairs,2 and statutory protection of the public, shareholders, and corporate creditors has often been sacrificed.3

Not all states have been enthusiastic about statutorily favoring management in order to compete with states of lesser commercial importance. However, primarily because they felt powerless to resist, most states have to some extent acquiesced and followed Delaware's lead.4

In contrast to the pro-management bias of Delaware law, California has traditionally emphasized protection of the interests of corporate

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2. A short definition of internal corporate affairs is "the relations inter se of the corporation, its shareholders, directors, officers or agents . . ." Restatement (Second) of Conflict of Laws § 302, comment a at 307 (1971). A more expansive definition was provided by the Supreme Court of Maryland in 1885: "[W]here the act complained of affects the complainant solely in his capacity as a member of the corporation, whether it be as stockholder, director, president, or other officer, and is the act of the corporation, whether acting in stockholders' meeting, or through its agents, the board of directors, then such action is the management of the internal affairs of the corporation . . .["]. North State Copper & Gold Mining Co. v. Field, 64 Md. 151, 154, 20 A. 1039, 1040 (1885). The basic distinction to be made is between acts peculiar to corporations (internal affairs) and acts performed by individuals as well as corporations (external affairs). See Reese & Kaufman, The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit, 58 Colum. L. Rev. 1118, 1124 (1958) [hereinafter cited as Reese & Kaufman].
4. The classic statement is that of "the Governor of Michigan, in his 1921 message to the Michigan Legislature . . . that it was useless to pass a stringent corporation act because 'all of our corporations will come back to us as foreign corporations.'" Kaplan, supra note 1, at 436.
shareholders and creditors.\textsuperscript{5} As will be shown, the ability of corporations to change domiciles freely creates a tension between permissive states such as Delaware and more regulatory states such as California. This tension has led to the inclusion in California’s revision of its corporation law\textsuperscript{6} of a section that attempts to combat the power of the permissive states. The success of California’s effort should be of great interest nationwide. A successful effort by California to remedy the current ease with which corporations can avoid undesirable aspects of local law would offer all states an alternative to the surrender of important prerogatives to Delaware and other permissive jurisdictions.\textsuperscript{7}

California’s effort takes on special importance in light of the increasing interest in a federal statute to replace the current “lowest common denominator” system\textsuperscript{8} of state corporate law.\textsuperscript{9} There is a vigorous defense to be made, of course, for the rights of states to control their local affairs and for the existence of local laboratories for the law.\textsuperscript{10} But these arguments will not fend off federal intervention forever if the states cannot provide corporate regulation sufficient to protect the public interest. Arguably some states will favor a federal role as actually entailing a smaller reduction of their power to determine the nature of the governing corporation statute. All states have representation in Congress where their interests are likely to receive at least some consideration, whereas Delaware has demonstrated a tendency to ignore the interests of other states. On the other hand, it is clear that for California and the other states which have been able to retain a relatively

\textsuperscript{7} Also at stake are incorporation fees. The desire for this revenue has been a prime factor in Delaware’s behavior. See W. CARY, CASES AND MATERIALS ON CORPORATIONS 13 n.11 (4th ed. 1969).
\textsuperscript{8} Cary, supra note 3, at 663.
\textsuperscript{9} See id., supra note 3; Kaplan, supra note 1, at 480; Symposium—An In-depth Analysis of the Federal and State Roles in Regulating Corporate Management, 31 BUS. LAW 869 (1976); Symposium—Federal Chartering of Corporations, 61 GEO. L.J. 71 (1972).
\textsuperscript{10} See, e.g., New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1931) (dissenting opinion).
greater regulatory thrust in their corporation codes, an increased federal presence would entail the loss of a great deal of legislative autonomy.

The key to preventing federal assumption of corporate regulation is proof that the states can and will provide adequate protection for shareholders and creditors. Scholars considering the question differ on whether the states have the ability to break Delaware's grip on the law of corporations. Some flatly conclude that "[s]tate action cannot be effective in providing a responsible corporate statute" and urge federal standards as the best solution. Other writers have concluded that the means are currently available although some doubt that the states have the will to implement them. The California statute may present the last opportunity for the states to provide the answers to such questions and to prove that they can handle the Delaware problem.

This note discusses the potential of the California statute as a means to combat the influence of the permissive states over corporate law. To ascertain the probable impact and success of California's statute, this note explores two major areas: (1) the mechanics of the statute and whether the loopholes it contains can be expected to vitiate its effectiveness and (2) whether the statute is so burdensome that foreign corporations operating in California will seek to avoid its application. Brief consideration is first given to the background of the Delaware problem and the solution California offers.

The Status Quo: The Delaware Problem

The inordinate leverage of Delaware, the most permissive state since 1913, arises from the combination of three facts: (1) corporations have historically been accorded complete freedom of choice in selecting and changing the situs of their corporate domicile; (2) corporations able to afford such luxuries will choose the regulatory system interfering least with management's power over the internal affairs of the corporation; (3) courts have nurtured this system by adopting a conflict of laws rule that the law governing the corporation's internal affairs is that of the state of incorporation. Given these facts, the most permissive state has tremendous influence because, from the viewpoint of management,
it is the most desirable place in which to incorporate. This note does not purport to pass judgment on the wisdom of regulatory versus permissive statutory schemes. Each state must achieve what it believes is the proper balance between the legitimate needs of management and the legitimate interests of investors. Yet the present system must be condemned because it makes it difficult or even futile for many states to enact corporate statutes significantly more regulatory than Delaware's.

At the core of the current situation is the conflict of laws rule that "[p]urely internal corporate affairs and management are governed by the law of the state of creation." This deference to the law of the domiciliary state allows a corporation to immunize itself from the regulation of its internal affairs by the law of states in which it operates. Simply stated, the potential for corporations to insulate themselves from local law puts a state in a defensive position with respect to the stringency of its corporate statute if an alternative more favorable to management is provided by another state. Such an alternative was supplied by New Jersey in 1896 when it adopted what is regarded as the first of the modern liberal general corporation statutes. Delaware copied the New Jersey statute so that when New Jersey strengthened its law relating to

16. 17 W. FLETCHER, Cyclopedia of the Law of Private Corporations § 8326, at 110 (rev. ed. 1960) [hereinafter cited as FLETCHER]. The origins of the rule are ancient. When first chartered by English kings, corporations were conceived as artificial beings existing only by virtue of the sovereign's largesse and thus were subject to the sovereign's regulatory power. See Berle, Historical Inheritance of American Corporations, in Social Meaning of Legal Concepts: No. 3—The Powers and Duties of Corporate Management 189, 192-93 (1930); Williston, History of Business Corporations Before 1800 (pts. 1-2), 2 Harv. L. Rev. 105, 149 (1888). American courts adopted this analysis as shown by Chief Justice Marshall's description of the corporate entity as "an artificial being, invisible, intangible, and existing only in contemplation of law." Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819). When corporations began to operate in states other than the state creating them, comity between the states led to the practice of "recognizing" the corporation for the purpose of doing business there. See FLETCHER, supra, §§ 8330-46; R. LEFLAR, American Conflicts Law 597 (1968). Until recently, this rule often took a rather extreme form. Some courts even refused to take jurisdiction over suits involving the internal affairs of foreign corporations on the ground that such matters should be left for adjudication by courts in the state of incorporation. See Rogers v. Guaranty Trust Co., 288 U.S. 123 (1933); FLETCHER, supra, § 8425; LEFLAR, supra, at 606-09; Annot., 155 A.L.R. 1231 (1945); Note, The "Internal Affairs" Doctrine in State Courts, 97 U. Pa. L. Rev. 666 (1949). Courts justified their position on the grounds of the difficulty of a foreign court interpreting and applying a foreign law or of their inability to enforce a decree. This approach, the so-called "internal affairs doctrine," is now subsumed in the relatively new doctrine of forum non conveniens. See Williams v. Green Bay & W.R.R., 326 U.S. 549 (1946); Note, Forum Non Conveniens as a Substitute for the Internal Affairs Rule, 58 Colum. L. Rev. 234 (1958).
corporations and trusts in 1913, Delaware continued to offer the liberal alternative. The presence of a more permissive statute left to other states no choice but to imitate its liberality. As Justice Brandeis observed in *Liggett Co. v. Lee*:

> [I]t was futile to insist upon [stricter requirements]; because local restriction would be circumvented by foreign incorporation. Indeed, local restriction seemed worse than futile, . . . [T]he great industrial States yielded in order not to lose wholly the prospect of the revenue and the control incident to domestic incorporation.  

Thus, states have faced a dilemma: how to retain control over corporations operating within their borders without diluting the protection afforded by domestic law to minority shareholders, creditors, and others endangered by unscrupulous corporate practices.

**Tackling the Delaware Problem: The Background to California's Attempt**

No state has yet devised and consistently applied an approach that adequately deals with the Delaware problem. This is true notwithstanding occasional judicial attempts to apply local law to foreign corporations and various attempted statutory solutions. The failure to devise a means adequate to break the leverage of the most permissive state has occurred despite the holding in *Paul v. Virginia* that a corporation is not a citizen within the meaning of the privileges and immunities clause and that, therefore, a state has the power to refuse a corporation permission to do intrastate business within its borders. The primary use to which states have put this power is the requirement that foreign corporations register before doing intrastate business and submit to local service of process. Such requirements have slight impact on the internal affairs of corporations.

It is clear, however, that a state's right to refuse a foreign corporation entrance into the state is not limited to achieving such minimal

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18. 288 U.S. 517, 557-60 (1933) (dissenting in part).
20. 75 U.S. (8 Wall.) 168 (1868).
21. The corollary of this principle is that a state has no power to exclude a foreign corporation for doing *interstate* business. The reason that a state can discriminate against a foreign corporation at all is that a corporation is not a "person" within the meaning of article IV, section 2 of the United States Constitution (privileges and immunities clause). See Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519 (1839).
23. In fact, the Model Business Corporation Act specifically states that "nothing in this Act contained shall be construed to authorize this State to regulate the organization or internal affairs of such a corporation." MODEL ACT, supra note 22, § 106.
purposes. In *Railway Express Agency, Inc. v. Virginia*,\(^{24}\) the Supreme Court upheld Virginia's right to require a Delaware corporation to incorporate its Virginia operations in Virginia.\(^{25}\) In rejecting the corporation's argument that this burdened the interstate commerce in which it was primarily engaged, Justice Holmes commented:

> [Virginia] simply is refusing to grant a foreign corporation a permit to transact local business without taking out a charter from the jurisdiction within which that business must be done. There is no substantial evidence that the refusal would impose a burden on interstate commerce and it is presumed to be constitutional.\(^{26}\)

In light of modern commercial affairs, however, the wisdom of a universal application of such an approach is questionable.\(^{27}\) Breaking what are now large corporate units into a separate unit within each state would doubtless impair corporate efficiency and have a negative impact on the national economy. The fact that this approach has not been more frequently used suggests that the states believe the public interest to be better served by the current system.

Individual state courts have occasionally refused to follow the general rule of looking to the law of the domiciliary state to govern the corporation's conduct of its internal affairs.\(^{28}\) These cases generally have involved foreign corporations operating entirely within the state in which the court was sitting and which were "foreign" only in the sense that it was incorporated in another state. Such corporations are generally denominated "pseudo-foreign corporations,"\(^{29}\) and in the course of applying local law to them, courts have used such descriptions as "tramp" or "migratory,"\(^{30}\) or have remarked that their "residence . . . anywhere else outside of California, is the merest fiction."\(^{31}\) The most noted case

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25. This case is an example of the power of the state to require a foreign corporation to become "domesticated." See *Fletcher*, *supra* note 16, § 8303; H. *Henn*, *Law of Corporations* 236 (2d ed. 1970) [hereinafter cited as *Henn*].


27. See *Kaplan*, *supra* note 1, at 444-45.


29. The term "pseudo-foreign corporation" is not used in the new California code, but it is used in the legislative report concerning the revision. See *Report of the Assembly Select Committee on the Revision of the Corporations Code* (1975) [hereinafter cited as Assembly Select Committee Report].

30. See *Cumberland Tel. & Tel. Co. v. Louisville Home Tel. Co.*, 114 Ky. 892, 896-97, 72 S.W. 4, 5 (1903); *State v. Georgia Co.*, 112 N.C. 34, 41, 17 S.E. 10, 12 (1893); *Toklan Royalty Corp. v. Tiffany*, 193 Okla. 120, 122, 141 P.2d 571, 573 (1943).

not following the general rule is *Mansfield Hardwood Lumber Co. v. Johnson*, which involved a family lumber business, incorporated in Delaware but doing all of its business in Louisiana. In an action for rescission of the sale of their stock, the minority shareholders alleged that the majority had engaged in fraud to acquire the minority's stock at an unfair price while planning to liquidate corporate assets at an inordinate profit. The Louisiana district court applied Louisiana law and found for the plaintiffs. The United States Court of Appeals for the Fifth Circuit initially affirmed, but a rehearing was granted following a strong protest by the defendants that Delaware law should have been applied. The Fifth Circuit responded:

Those decisions . . . are, however, in our opinion, either inapplicable or unsound where the only contact point with the incorporating state is the naked fact of incorporation, and where all other contact points . . . are found in another jurisdiction . . . [W]here neither the charter nor the statutory laws of the incorporating state are applicable, and all contact points are in the forum, we believe that the laws of the forum should govern.

Applying local law to corporations which are essentially local in character as in *Mansfield* represents at least one method of defeating the benefits of foreign incorporation. However, a case-by-case application of local law only captures those foreign corporations which are before local courts in lawsuits involving their internal affairs. In addition, the decision to apply local law would be left to individual judges, many of whom may be hesitant to leave the firm ground of the general rule. Finally, having no guidance in differentiating between the real foreign corporation and the pseudo-foreign corporation, courts would most likely apply local law only to those foreign corporations doing all of their business within the jurisdiction of the court. And it is possible that the number of corporations falling into this group is so small that this method of applying local law would do little to ease the grip of the permissive states.

These weaknesses are eliminated if the legislature undertakes to develop a statutory set of guidelines. A statutory approach facilitates the adoption of a definition of pseudo-foreign corporations that is not

33. Two of the Fifth Circuit's assumptions—that the corporation did all of its business in Louisiana and that a different result would have obtained if Delaware law had been applied—have been questioned. Note, *Pseudo-Foreign Corporations and the "Internal Affairs" Rule*, 1960 Duke L.J. 477 (1960).
35. 263 F.2d 748 (5th Cir. 1959).
limited to corporations doing all of their business in the state. North Carolina, in 1955, was the first state to attempt adoption of a statute applying certain provisions of local corporation law to the internal affairs of pseudo-foreign corporations. This controversial aspect was eliminated, however, from the corporate act finally adopted. In 1963 New York adopted such a statute as part of the total revision of its corporation law. This statute requires the application of certain provisions of local law to a foreign corporation unless it does less than one-half of its business in New York. Although similar in intent to the New York statute, California’s statute should provide a better test of the approach, since California’s specific aim is to extend to pseudo-foreign corporations its traditional protection of the rights of shareholders and creditors. New York, on the other hand, was as interested in liberalizing its entire statute to keep pace with the more permissive states as it was in foreclosing use of foreign incorporations as a means of escaping local regulation.

California’s Remedy

Section 2115 of the revised Corporations Code is the cornerstone of California’s new statutory attempt to assert some degree of regulatory control over the internal affairs of pseudo-foreign corporations operating within the state. Subsection (a) defines which foreign corporations are subject to California law, while subsection (b) makes specific code sections governing domestic corporations applicable to the “subject” foreign corporations. Thus, in the areas covered by these particular sections, there is no distinction between the treatment of corporations actually domiciled in California and pseudo-foreign corporations merely operating in California. It is to be noted that not all of the California Corporations Code is applied to a pseudo-foreign corporation. Rather, the pseudo-foreign corporation must comply only with those sections

37. Latty, supra note 12, at 137 n.1.
38. New York’s statute is phrased in the negative. The applicable statutes state that they apply to all foreign corporations while another statute exempts corporations which are listed on a national securities exchange or are not “psuedo-foreign.” See N.Y. BUS. CORP. LAW §§ 1317-20 (McKinney 1963 & Supp. 1975).
39. Citing one of their interim reports, Professor Henn states that “[o]ne ever-present strand in the thinking of the Joint Legislative Committee was to ‘foster New York incorporation of businesses and retention of existing business corporations thereby contributing to economic progress and opportunities for the citizens of our State.’” Henn, The Philosophies of the New York Business Corporation Law of 1961, 11 BUFFALO L. REV. 439, 453 (1962). Doubt concerning whether the New York law has an impact on foreign corporations is heightened by the absence of reported cases decided under them. One reason for this may be a major loophole in New York’s statute. See note 58 & accompanying text infra.
41. See note 65 infra.
which are enumerated, plus the sections applicable to all foreign corporations.  

Section 2115(a): Two Tests Determine Whether a Foreign Corporation is Subject to California Law

A foreign corporation is within the code sections enumerated in section 2115(b) if it does intrastate business in California and satisfies two tests stated in section 2115(a). The first is a local business test which requires that the foreign corporation do more than 50 percent of its business in California. The percentage of business in California is determined by averaging the corporation's property factor, payroll factor, and sales factor. These factors are already computed by foreign corporations doing business in California to determine business income apportionable to California for franchise tax purposes.


44. "The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year." CAL. REV. & TAX. CODE § 25129 (West 1970); see id. §§ 25130-31.

45. "The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year." CAL. REV. & TAX. CODE § 25132 (West 1970); see id. § 25133.

46. "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year." CAL. REV. & TAX. CODE § 25134 (West 1970); see id. §§ 23135-36.

47. "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." CAL. REV. & TAX. CODE § 25128 (West 1970).

In the tax area, "[t]he reasonableness of this formula has been repeatedly upheld. It gives weight to the major elements responsible for the earning of income while, at the same time, it strikes a balance between a formula containing a larger number of factors, which might prove cumbersome to administer, and a formula containing a fewer number of factors, which might produce distorted results." Keesling & Warren, California's Uniform Division of Income for Tax Purposes Act (Part II), 15 U.C.L.A.L Rev. 655 (1967). California's statutes for the allocation of corporate income are almost a verbatim adoption of the Uniform Division of Income for Tax Purposes Act which was drafted and sponsored by the National Conference of Commissioners of Uniform State Laws in 1957.
factor represents California's percentage of the corporation's total activity in each of the three areas. If the average of the three factors exceeds 50 percent, the corporation satisfies the local business test and can be said to do most of its business in California. The second test, which is based on the degree of local ownership of the corporation, is satisfied if more than one-half of the voting stock of the foreign corporation is owned by persons having addresses in California.  

These two tests define the point at which California deems a foreign corporation's connection with the state sufficient to justify regulation of its internal affairs by California law. Since California's interest under both tests must exceed 50 percent, the pseudo-foreign corporation's connection to any other state or combination of states cannot be greater than its connection to California. Thus, these tests assure that California will not apply its law to corporations which are really national entities.

California will obtain the data necessary to determine whether the corporation is pseudo-foreign by requiring every foreign corporation qualified to do business in California to file annually an officers' certificate stating the corporation's property, payroll, and sales factors and the percentage of its voting stock that is held by Californians.  

Since reporting the percentage of business in California essentially involves the mere transfer of figures already generated by the corporation for its franchise tax reports, this aspect of the required report imposes no real burden on the corporation. The annual computation of the percent of voting securities held by persons with addresses in California also should not impose a great burden on the foreign corporation. If the corporation has so many shareholders that a manual computation would be burdensome, then it is probable that the shareholder records of the corporation are computerized.

48. CAL. CORP. CODE § 2115(a) (West Supp. 1976) (eff. Jan. 1, 1977). The fact that California residents held about half of a corporation's outstanding stock was important to the result in at least one case. See Western Air Lines, Inc. v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961).

49. CAL. CORP. CODE § 2108(a) (West Supp. 1976) (eff. Jan. 1, 1977). The property, payroll and sales factors are computed for the corporation's previous tax year. Id. § 2115(a). The percent of voting securities held by persons with addresses in California is computed as of the last record date for a shareholders' meeting. Id. § 2108(a)(1). If the California portion of the corporation's activities and ownership exceeds 50% on both of these tests, it becomes subject to California law on the first day of the corporation's next fiscal year which commences thirty days or more after the report is filed. Id. § 2115(c). The corporation ceases to be a pseudo-foreign corporation of California at the end of the fiscal year in which an annual report shows that the corporation did not meet one of the tests. Id. § 2115(d). The penalty for not filing the required report is mandatory forfeiture of the corporation's right to do intrastate business, but the secretary of state may only do this after six month's notice of delinquency. Id. § 2108(d).
Loopholes: Ample Means to Avoid the California Law

If a foreign corporation meeting the tests of section 2115 finds the various applicable provisions of the new corporation law more onerous than those of its domiciliary state, it will undoubtedly attempt to evade the tests of section 2115. Efforts to avoid section 2115 can be expected to take three general forms: (1) use of the statutory exemption of corporations listed on certain national securities exchanges; (2) attempts to reduce artificially California's interest as computed under either of the two tests; and (3) actual reduction of the corporation's connection to California.

First, it is important to note that section 2115 does not apply to any corporation with outstanding securities listed on any national securities exchange certified by the commissioner of corporations under section 25100(o) of the Corporations Code. The theory behind this exemption is that when a corporation lists its shares on a national exchange, it subjects itself to federal securities regulations and exchange requirements which supposedly provide protection for investors equivalent to that provided under California law. The exemption is only rational, however, if the protection afforded under the federal statutes is in fact equivalent.

The first thing to note about the exemption of listed corporations is that both exchange regulations and federal securities law focus primarily on disclosure of material information to shareholders and to the marketplace, thus duplicating some aspects of California's disclosure provisions. They do not, however, deal with all of the areas California considers important enough to apply to pseudo-foreign corporations. For example, they do not provide standards for director election and removal, a director's standard of care, and a right to cumulate votes in the election of directors. As to such areas, the law of a corporation's domicile would continue to control. This gap in California's effort to set the standards of conduct for pseudo-foreign corporations brings into question the propriety of this exemption. This concern is enhanced by the fact that the divorce of shareholders and management which occurs

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50. Id. § 2115(e). Apparently listed corporations are not even required to file the officer's certificate. See id. § 2108(a).

The national securities exchanges certified to date by the commissioner of corporations under California Corporations Code section 25100(o) are the New York and American Stock Exchanges. See Commissioner's Release No. 27-c (March 4, 1972). The initial draft of the bill also provided for the exemption of corporations with outstanding securities on the list of over-the-counter margin stocks issued by the Board of Governors of the Federal Reserve System. A.B. 376 (1975) (as amended Aug. 5).


52. See notes 99-116 & accompanying text infra.

53. See note 65 infra.
in larger corporations may create a greater need for shareholder protection. Arguably, national security exchanges provide another form of protection. The existence of a public market enables the shareholder to quit the corporation by selling his stock. This negative form of protection hardly seems sufficient to support the exemption, however, when California does not exempt from these same provisions its domestic corporations which are listed on the same national exchanges.

The second consideration involved in the listing exemption is that it is only available to corporations of a large size. To be eligible for listing, a corporation must meet certain minimum standards set by the exchanges, including a minimum number of shareholders, a minimum amount of tangible assets, and a minimum level of earning power. The fact that this exemption is necessarily limited to larger corporations may suggest that an important reason for its enactment was to avoid political opposition from those corporations with the greatest power to prevent the adoption of section 2115.

The other two methods a pseudo-foreign corporation might use to avoid the more burdensome California requirements involve efforts to fall below 50 percent on either of California's local interest tests. Since California's interest in the corporation must exceed 50 percent under both of these tests before the corporation is deemed a pseudo-foreign corporation, the corporation need only bring itself below 50 percent on one of them. It is reasonable to assume that pseudo-foreign corporations would prefer a cosmetic manipulation of these tests rather than any real change in business practices that might prove unprofitable. Cosmetic changes are more likely to be successful in evading the local ownership test than in evading the local business test. This is so primarily because the local business test is based on the factors used to allocate corporate income to California for franchise tax purposes. Short of fraud, the computation of these factors is not susceptible of artificial manipulation. And California did foreclose the one method a corporation might have used to maneuver around the local business test—the formation of a controlled subsidiary to do all the California business for the corporation. California requires a parent and any subsidiary of which it owns more than 50 percent of the outstanding voting shares to report their income on a consolidated basis, after elimination of intercompany transactions.

54. HENN, supra note 25, at 626.
55. See notes 43-48 & accompanying text supra.
56. See notes 44-47 & accompanying text supra.
57. Even though the subsidiary would meet the tests and become subject to California law, the controlling parent's internal affairs would remain relatively unaffected.
On the other hand, there seems to be more room for manipulation to bring local ownership below 50 percent, without actually changing the true location of the ownership of the corporation. Local ownership is tested by determining the percentage of the corporation’s outstanding voting securities held by persons having addresses in California, not the percentage of shareholders in California. The key phrase in the test, “held of record by persons having addresses in this state,” is new and somewhat ambiguous. Does it provide for computation of local ownership based on the addresses of the voting shareholders that appear on the corporation’s records or is the determination based on whether the shareholder has an address in California, regardless of his address of record? Certainly the former interpretation is more compatible with the requirement that the corporation itself make the annual computation of voting shares owned by Californians. Could corporations be expected to ascertain whether a shareholder has any address in California?

If the address on which local ownership is tested is the address in the corporate records, then only that address need be changed to effect a reduction of California ownership. Thus shareholders who feel adequately protected by the size of their holdings or who are aligned with management may by sham transactions remove the corporation from the coverage of California law. Such transactions could range from simply having all correspondence from the corporations mailed to an address outside California to the establishment of a voting trust in another state. Such artificial manipulations could be prevented by interpreting the phrase “having addresses in this state” to require that the shares of a shareholder who has any address in California be counted as locally owned. Another solution would be to construe the phrase as meaning owned “either beneficially or of record;” this is the language of the New York statute as originally enacted. Both solutions might place an onerous record keeping burden on the corporation with no real means of verification.

Despite such an interpretation, another method may exist to reduce local ownership without changing the true location of the owners. Apparently to solve the problem that arose in *Western Air Lines, Inc. v.*

60. This method would succeed because the trustee would be made the holder of record.
Sobieski, where approximately 50 percent of the corporation’s shares were held by broker-dealers and the court refused to make assumptions about whether Californians owned those shares, California added the provision that “[f]or the purpose of this subdivision, any securities held to the knowledge of the issuer in the names of broker-dealers or nominees for broker-dealers shall not be considered outstanding.” This provision could backfire badly in that it enables California owners to place their shares in the names of broker-dealers and avoid having those shares counted as locally owned. Militating against this result is the possible loss of the right to vote the shares that might occur, depending upon the relationship of dealer and owner.

Such devices may be most useful to closely held foreign corporations, to foreign corporations in which a few shareholders own large blocks of stock, or to foreign corporations in which California ownership is only marginally more than one-half. It should be remembered that many of the corporations California attempts to capture moved their domiciles from California to the states which give management a freer hand and shareholders less protection. That a sufficient number of shareholders were willing to approve such a move may indicate that a sufficient number would also be willing to participate in an evasion of the local ownership test.

The final means to avoid California law would be for the corporation to make an actual reduction of its connection with California to below 50 percent under either the local business or local ownership test. To reduce the level of local ownership, shareholders of major blocks could be convinced to move from California, or perhaps the corporation could market future shares only outside of California. A sufficient reduction of local business could be accomplished by relocating parts of the corporation’s operation in other states, by expanding in other states rather than in California, or simply by making property investments in other states. Note, though, that a reduction of California’s share of either payroll, property, or sales will not defeat the local business test if the average of the three exceeds 50 percent. To the extent pseudo-foreign corporations use this method to avoid California’s corporation law, California will have driven out corporate activity which would have produced local jobs and taxes.

Section 2115(b): The Law Applicable to Pseudo-foreign Corporations

Section 2115(b) enumerates the California statutes applicable to

64. It certainly is not inconceivable that a court could be convinced on the proper evidence to look through this or any of the other sham transactions discussed, to ascertain the true nature of the corporation’s connection with California.
corporations which are pseudo-foreign under section 2115(a). Only
these select provisions of the Corporations Code are applied to the
subject foreign corporations.65

Before comparing these statutes with provisions in the law of other
jurisdictions, an important question must be addressed: are these stat-
utes intended to operate only in California or to apply to the corporation
throughout its operation? Since the statutes made applicable to pseudo-
foreign corporations concern corporate internal affairs, each of which is
generally done only once for the entire corporation and for which the
corporation may have only one policy,66 these standards must apply
throughout the corporation. For instance, either the corporation pays a
certain dividend to all its shareholders or it cannot pay it to any
shareholders; it either indemnifies a director or it does not; and either all
shareholders have the right to cumulate votes or they do not. In such
situations the corporation can be held to only one standard of conduct if
parity is to exist among equal members of the corporation and if the
corporation is not to be broken de facto into smaller units.

This is not to suggest that California law will be in irreconcilable
conflict with the law of the foreign corporation’s domicile. California
provides for higher standards of corporate conduct than those provided
by other states.67 Corporate law tends not to be a set of hard and fast
rules under which conflicts between different state schemes must of

65. Section 2115(b) reads as follows: “The following chapters and sections of
this division shall apply to a foreign corporation subject to this section (to the exclusion
of the law of the jurisdiction in which it is incorporated): Chapter 1 (general provisions
and definitions), to the extent applicable to the following provisions; Section 301 (an-
annual election of directors); Section 303 (removal of directors without cause); Section
304 (removal of directors by court proceedings); Section 305, subd. (c) (filling of direc-
tor vacancies where less than a majority in office elected by shareholders); Section 309
(directors’ standard of care); Section 316 (excluding subdivisions (a)(3) and (f)(3))
(liability of directors for unlawful distributions); Section 317 (indemnification of di-
rectors, officers, and others); Sections 500 through 505 (limitations on corporate distri-
butions in cash or property); Section 506 (liability of shareholder who receives unlawful
distribution); Section 600, subdivisions (b) and (c) (requirement for annual shareholders’
meeting and remedy if same not timely held); Section 708, subdivisions (a), (b)
and (c) (shareholder’s right to cumulative votes at any election of directors); Chapter
12 (reorganizations); Chapter 13 (dissenters’ rights); Sections 1500 and 1501 (records
and reports); Chapter 16 (rights of inspection).” CAL. CORP. CODE § 2115(b) (West

In applying only selected provisions, which reveal a strong legislative policy for
protecting local interests as defined by the 50% tests, California follows the suggestion of
Latty. See Latty, supra note 12, at 159-60.

66. See note 2 supra.

67. Occasionally a statute may provide that a higher standard may be adopted by
the corporation. See, e.g., CAL. CORP. CODE §§ 305(c), 3632 (West 1955 & Supp. 1976)
(eff. until Jan. 1, 1977); DEL. CODE ANN. tit. 8, §§ 102(b)(1), (4), 141(b), (h), 229,
necessity arise; rather each state merely sets the minimum standards it considers necessary to protect and promote the various interests. Thus, in most cases a foreign corporation will satisfy the low standards of its domiciliary law by meeting the more rigorous standards set by California. But the corporation’s need for a single standard of conduct remains. What California proposes to do is to step into the position presently occupied by the domiciliary state and supply the standards for the corporation.

If California law is to displace the law of the domiciliary state as the single standard of conduct for the pseudo-foreign corporation, courts in all states must apply the California standards to the pseudo-foreign corporations of California which are before them. This entails the abandonment of the age-old conflict of laws principles which sends courts for guidance to the law of the corporation’s domicile. A new conflicts rule must be adopted; the state with the predominant interest, defined as an interest in excess of one-half, should be able to claim the right to govern the corporation’s internal affairs. To effect this change, California should undertake a serious effort to educate other states on the equities of such a solution. A properly mounted public relations campaign would gain allies for California in its battle to overcome the general conflict of laws rule favoring the domiciliary state. In addition,

68. One area on which California law and domiciliary law might conflict is the question of removal of a director without cause. See notes 87-97 & accompanying text infra.

69. This argument is stressed in Reese & Kaufman, supra note 2, at 1125-26.

The need for a single standard is well founded, both on the need for equal treatment within the same class of a corporation’s members and on considerations of corporate efficiency. Certainly it would be both unequal and chaotic if different states measured the same conduct by different standards and reached different results. Consider the feasibility of a system in which shareholders in one state were given the right to cumulate votes while in another shareholders were denied that right.

An additional consideration is the need for predictability in corporate law. It is important for the corporation to know with at least some certainty whether a given course of action will withstand challenge. It should be recognized that the need for a single standard explains in large measure the vitality of the rule that courts look to the law of the corporation’s domicile for governance of the corporation’s internal affairs.

70. An interesting problem will arise where California’s law is less strict than the domiciliary law. A concrete example is the difference between the requirements of California and Delaware as to the amount of time that must have passed since the last annual meeting before shareholders may initiate a court action to compel the holding of the meeting. Delaware has a shorter time limit and thus provides greater shareholder protection. See note 74 & accompanying text infra. Since California’s interest is shareholder protection, arguably where the domiciliary’s standard is more protective of shareholders, the domiciliary’s standard could be used. The better analysis may be, however, that both the adoption of a standard that California believes to be adequate and the need for uniformity require that California’s standard always override domiciliary law even where the California standard is less strict.
to aid courts both within and without California, there should be clear identification of these corporations. This could be accomplished by public lists issued and updated regularly by the secretary of state.

**Burdens Imposed by the California Law**

We come now to the question whether California's statutes will impose upon pseudo-foreign corporations a significantly higher standard of conduct than that imposed by the law of their domiciles. A complete comparison of California's statutory corporate law with that of all other states is beyond the scope of this note. However, emphasis will be placed upon certain key provisions of California law which the new statute renders applicable to pseudo-foreign corporations, the attempt being to determine in broad terms whether such provisions are significantly more onerous than the comparable provisions under Delaware law. This analysis should first indicate what kinds of shareholder and creditor protection are at stake in the battle between California and the permissive states. Second, it will provide some insight into the vigor with which corporations can be expected to resist California's attempt to apply its local law to them.

**Election of Directors: Burden Significantly Greater Under California Law**

The first statutes to be examined are those dealing with shareholder meetings and the election of directors of the corporation. California's new corporations law requires all domestic and pseudo-foreign corporations to hold an annual meeting to elect directors.\(^71\) This section is taken from Delaware law.\(^72\) If the annual meeting is not held within a given time, the superior court is empowered, upon application of any shareholder and after notice to the corporation, to order the meeting to be held.\(^73\) Delaware also provides for similar enforcement, but interestingly, Delaware has shorter requirements as to the amount of time which must elapse before shareholders may proceed in court.\(^74\) Most states have similar requirements and provide a way for shareholders to compel the corporation to hold the meeting.\(^75\)

To provide minority shareholders with the means to acquire representation on the board of directors, the new California law has a unique

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72. DEL. CODE ANN. tit. 8, § 211(b) (1974).
73. CAL. CORP. CODE § 600(c) (West Supp. 1976) (eff. Jan. 1, 1977). The period is sixty days after the date for the annual meeting or, if none is designated, the period is fifteen months after either the organization of the corporation or the last annual meeting.
74. DEL. CODE ANN. tit. 8, § 211(c) (1974). Delaware requires thirty days to have elapsed since the designated date for a meeting or thirteen months to have elapsed since the last annual meeting.
75. See Henn, supra note 25, 375-76.
cumulative voting statute applicable as well to pseudo-foreign corporations. Under this statute a shareholder may not cumulate his votes if no shareholder has given notice at the meeting prior to the vote that he intends to cumulate his votes. But once notice has been given, all shareholders may cumulate votes, so long as the names of the candidates for whom votes will be cumulated were placed in nomination prior to the voting.77

Although all but three states have statutes which pertain to cumulative voting, many, including Delaware, simply permit the corporation to decide for itself whether shareholders may cumulate votes. Since the corporation's majority, which probably will see cumulative voting as a threat to its power, determines the corporation's policy on this subject, the right California gives every shareholder to cumulate votes after notice could result in a significant change for pseudo-foreign corporations.

Even where shareholders have the right to cumulate votes, however, devices such as staggered or classified boards often exist to dilute the potency of the right to cumulative voting by reducing the number of positions on which an individual shareholder may vote. California rules out staggered boards by requiring that "[a]t each annual meeting directors shall be elected to hold office until the next annual meeting." This section obviously mandates the election of the entire board at each annual meeting. Other means of diluting the effect of cumulative voting are available in California. For example, the articles of incorporation may provide that shareholders are to vote by class or series. This is a device which can be used to reduce the number of votes an individual shareholder has to cumulate. For instance, a shareholder may be a member of a class which has the right to elect only one

77. CAL. CORP. CODE § 708(b) (West Supp. 1976) (eff. Jan. 1, 1977). These notice requirements were included to "promote fairness in the use of cumulative voting ...." REVISION COMMITTEE REPORT, supra note 29, at 88. The California statute is unique because it provides for notice any time before the vote. This may raise substantial problems with regard to the solicitation of proxies.
78. The states are Massachusetts, New Hampshire, and South Carolina. MODEL ACT, supra note 22, at § 33, para. 4; DEL. CODE ANN. tit. 8, § 214 (1974).
79. See, e.g., id., § 33, para. 4; DEL. CODE ANN. tit. 8, § 214 (1974).
80. There is an argument that staggered terms for directors provide for more continuity on the board of directors and are more efficient in that longer periods mean directors have a chance to educate themselves more completely and to put their knowledge to use. This argument is at least partially answered by the fact that, even where entire boards are elected annually, the same persons are frequently reelected repeatedly.
82. Id.
or two or even no directors.\textsuperscript{83} Also, California sets no minimum number of directors that a pseudo-foreign corporation must have,\textsuperscript{84} so that a straight reduction of the number of directorships to the minimum set by domiciliary law could be used to diminish the effect of California's cumulative voting requirement.\textsuperscript{85} Other means to mitigate the effectiveness of a cumulative statute, such as issuing nonvoting shares, setting up voting trusts and voting agreements, or having the board act through committees are available to the extent such rights exist under the law of the corporation's domicile.\textsuperscript{86}

Thus, in the area of election of directors, the greatest burden of California law is its cumulative voting provision. Although means may exist to dilute the effect of this statute, such means are themselves burdensome. Management's notorious dislike for cumulative voting suggests that this provision of the California law alone may be sufficient to cause foreign corporations to avoid becoming subject to California law.

\textbf{Removal of Directors: The Burden Varies}

California provides that the shareholders of a pseudo-foreign corporation may remove without cause any or all of the corporation's directors by a vote of the majority of the outstanding shares, subject to provisions protecting cumulative and class voting procedures.\textsuperscript{87} Pre-

\begin{itemize}
\item \textsuperscript{83} However, for a corporation which has only one class of shareholders to sub-divide into several classes may be a difficult and costly process, as the shareholders must be convinced to surrender their old shares for new ones with different rights.
\item \textsuperscript{84} California requires that domestic corporations have at least three directors, except where the corporation has two or fewer shareholders. \textit{Cal. Corp. Code} § 212(a) (West Supp. 1976) (eff. Jan. 1, 1977).
\item \textsuperscript{85} A large board has certain advantages, such as providing more persons to do the board's work and providing a greater diversity of viewpoints, which may make a reduction in the number of board seats an unappealing means to avoid cumulative voting.
\item In a section not applicable to pseudo-foreign corporations, California protects cumulative voting in domestic corporations against such an attack by providing that a reduction of "the minimum number of directors cannot be adopted if the votes cast against its adoption \ldots would be sufficient to elect at least one director if voted cumulatively at an election at which all of the outstanding shares entitled to vote were voted and the entire number of previously authorized directors were then being elected." \textit{Id.}
\item \textsuperscript{86} In a California domestic corporation, the board may act through committees, may issue nonvoting shares, and the shareholders may create voting trusts. \textit{Id.} §§ 311, 400, 706. These sections are not applicable to pseudo-foreign corporations.
\item \textsuperscript{87} \textit{Id.} § 303. Cumulative voting is protected by providing that "[n]o director may be removed (unless the entire board is removed) when the votes cast against removal \ldots would be sufficient to elect such director if voted cumulatively at an election at which the same total number of votes were cast \ldots and the entire number of directors authorized at the time of the director's most recent election were then being elected \ldots." \textit{Id.} § 303(a)(1). Where class voting is provided for in the articles, it is protected by the provision that any director elected under class voting "may be removed
sumably, directors have the normal rights of notice and opportunity to be heard although they are not specified in California's statute. In adopting removal without cause, California follows the theory that since the shareholders are the owners of the corporation they should have complete power to control management. Thus, the right to remove hinges not upon the propriety of a director's conduct but upon the bare question whether the shareholders desire to retain him.

Through a possible oversight, there is a means specifically denied to domestic corporations by which pseudo-foreign corporations can protect directors from removal even beyond the protections afforded by the cumulative voting procedures. Domestic corporations are prohibited from placing in their articles a supermajority vote requirement for director removal. This section, however, does not apply to the pseudo-foreign corporation. If the domiciliary law permits, a supermajority vote requirement for director removal could be adopted by the California pseudo-foreign corporation.

In addition to providing for removal without cause, California retains its provision empowering a superior court of the county where the principal office of the corporation is located to remove a director for "fraudulent or dishonest acts or gross abuse of authority or discretion." Such a suit must be initiated by shareholders holding at least 10 percent of the outstanding shares of any class. This section is applicable to pseudo-foreign corporations.

While many corporation codes outside California deal with the removal of directors, a good number, including Delaware's, do not. As to Delaware, Professor Folk states, "Unlike many other state statutes, the Delaware law does not deal expressly with removal of directors . . . [but] stockholders of a corporation clearly have the inherent power to remove one or more directors for cause." A leading example of this inherent power is the famous case of Campbell v. Loew's, Inc., where only by the applicable vote of the holders of the shares of that class or series." Id. § 303(a)(2).

89. Model Act, supra note 22, § 39.
90. See note 87 supra.
91. Cal. Corp. Code § 204(a)(5) (West Supp. 1976) (eff. Jan. 1, 1977). A supermajority vote requirement is a provision, generally contained in the corporation's articles, which requires the vote of all or of a large proportion of a class or series of shares to approve a particular action.
92. Id. § 304.
93. Id. As the statute reads, apparently 10% of the shareholders of one class may even initiate the removal proceedings of a director elected by another class.
94. E. Folk, The Delaware General Corporation Law 57 (1972).
95. 36 Del. Ch. 563, 134 A.2d 852 (1957).
a director was removed for cause by a simple majority even though he was elected under cumulative voting required by the certificate of incorporation. Although the court recognized the "possibility of stockholder removal action designed to circumvent the effect of cumulative voting . . ." it found that this was outweighed by the consideration that a director should not be "free to continue such damage merely because he was elected under a cumulative voting provision."

In addition, Delaware has upheld removal without cause pursuant to a bylaw authorizing such action.

Whether California's director removal statutes are more of a burden to management than the right of shareholders to remove directors under Delaware case law is a question complicated by California's protection of cumulative voting rights. In providing for removal without cause in all cases, California law is more burdensome than Delaware's. The additional power of a court to remove for cause may also increase the burden under California law, as shareholders are given an alternate means to accomplish removal. Yet, because the provision added for the protection of cumulative voting applies to the removal of any director—even a director not elected under cumulative voting—the ultimate assessment of the burden on management is dependent upon who elected the director being removed. Where the director was elected under cumulative voting and represents minority shareholders who would otherwise not have a voice in management, then the statute can be said to burden management. Where the statute intended to protect cumulative voting operates to prevent the removal of a director not elected under cumulative voting, management may be more protected by California law than by Delaware's.

**Corporate Records and Disclosures: Burdens Significantly Greater Under California Law**

California deems some aspects of its law dealing with corporate records sufficiently important to apply them to pseudo-foreign corporations. California also gives the shareholder with a purpose "reasona-

96. *Id.* at 573, 134 A.2d at 858.
98. Some of these sections also apply to any foreign corporation having its principal executive office in California or customarily holding meetings of its board in this state, thus preventing a foreign corporation from establishing headquarters in California to avoid the reporting requirements of its domicile. *Cal. Corp. Code* §§ 1501(h), 1601(a) (West Supp. 1976) (eff. Jan. 1, 1977). California requires that pseudo-foreign corporations keep adequate and correct records and books of account, a record of its shareholders, and the minutes of the proceedings of its shareholders, board, or committees of the board. *Id.* § 1500. The minutes must be kept in written form, while the corporate records and shareholders list may be kept in any form capable of being converted to written form. *Id.* If the records are not kept in written form, the corporation has
bly related” to his interests as a shareholder the right to inspect during normal business hours the corporation’s “accounting books and records and minutes.” This follows the pattern in most states of allowing shareholders a qualified right of inspection. In California, this right extends to the records of each subsidiary of the corporation. The right of inspection may be exercised by an agent or attorney, may not be limited by the articles or bylaws, and can be enforced through the courts. The proper superior court is given the discretion to set the conditions of inspection and to order an independent audit. Delaware law generally imposes the same requirements.

Except in the case of a corporation with less than 100 shareholders of record which has expressly waived this requirement in its bylaws, every corporation must make an annual report to shareholders within 120 days of the close of its fiscal year containing the corporation’s balance sheet, an income statement, and a statement of changes in financial position in the fiscal year. In addition, a shareholder or shareholders of at least 5 percent of the outstanding shares of any class have the right to demand balance sheets and income statements for the three-month, six-month, or nine-month period of the corporation’s current fiscal year ending more than 30 days prior to the date of the request. If the corporation compiles such interim analysis, either on request of 5 percent of any class or for its own use, a copy of that interim report must be kept on file for 12 months and exhibited to any shareholder requesting to examine it. The corporation is also required to supply or mail to any shareholder so requesting, a copy of the last income statement and balance sheet the corporation has prepared. not complied with a request for inspection until it has made them available in written form at the corporation’s expense. Id. § 1605.

99. Id. § 1601(a). Confusion may arise because this section expressly applies only to those “foreign corporation[s] keeping any such records in this state or having its principal executive office in this state.” This phrase should be interpreted as relating only to genuine foreign corporations and not to pseudo-foreign corporations, which should be subject to this section no matter where their records are kept.

100. See HENN, supra note 25, at 395-402.


102. Id.

103. Id. § 1603. The court also may award reimbursement to the shareholder for his reasonable expenses in connection with such a proceeding if it finds his demand was proper and failure to comply unjustified. Id. § 1604.


106. Id.

107. Id. § 1501(c). Annual reports and interim statements of earnings are typically required of corporations whose shares are listed on national securities exchanges. See HENN, supra note 25, at 626-27.


109. Id. § 1501(d). Delaware has no provision requiring interim financial reports.
Superior courts of the proper county are empowered to enforce the shareholders' right to reports, extend the time limits in which the corporation may comply or award the shareholder reimbursement for expenses he has incurred to enforce these rights.  

California's provisions defining the shareholder's right to inspect and providing a means to enforce it are fairly typical, as shareholder inspection rights were recognized at common law to facilitate a shareholder's protection of his investment. In giving any shareholder with a "proper" purpose the right to inspect the corporation's financial records, California differs slightly from the position taken by the thirty-five states which condition the right to inspect upon ownership of stock for a minimum period or upon ownership of a minimum percentage of stock. Delaware also does not so condition the right of a shareholder with a proper purpose, and neither California nor Delaware follow the 1969 amendment to the Model Business Corporation Act adding the limitation that the right extends only to "relevant" books.

The California law on disclosure to shareholders does differ, however, from other state statutes in its requirement that the corporation disclose various significant transactions between the corporation and certain of its "insiders." Any corporation with 100 or more holders which is not regulated under section 12 of the Securities Exchange Act of 1934 (or is exempt from such requirements by section 12g of that act) must disclose this information in its annual report unless the transaction was approved by the shareholders. This disclosure requirement is new to California and unique among state statutory schemes; although, as the exemptions suggest, federal securities law requires similar disclosures.

110. Id. § 1501(f), (g). Delaware has similar provisions for court enforcement of shareholder inspection rights. Del. Code Ann. tit. 8, § 220 (1974).


112. Id.


114. Model Act, supra note 22, § 52. The comment states that this addition was made to protect "against the possibility of expensive and vexatious fishing expeditions." Although this addition removes any chance for doubt, it says no more than what the proper purpose requirement already provides.

115. According to section 1501(b), if the corporation has 100 or more holders of record, the corporation must disclose information concerning: (1) any transaction involving an amount in excess of $40,000 in which any director or officer or any holder of more than 10% of the outstanding voting shares had a direct or indirect material interest; and (2) any indemnification or advances aggregating more than $10,000, paid during the fiscal year to any officer or director pursuant to California's indemnification statute. Cal. Corp. Code § 1501(b) (West Supp. 1976) (eff. Jan. 1, 1977).

Thus, in the area of corporate records and disclosures, California differs materially from other states in two ways which could have significant impact on the pseudo-foreign corporation—the ability of 5 percent of the shares to demand interim income reports and the requirement of disclosure of the corporation's material inside transactions. The right to demand interim income reports could impose a significant accounting burden on smaller corporations, but it will probably not have much of an impact upon larger corporations because they are likely to have generated the necessary data already. What shareholders will do with the additional information cannot be forecasted. The right to demand such interim statements, however, at least creates the opportunity to follow their investment more closely and to react more quickly to changes in the corporation’s financial condition. The exposure of certain dealings between the corporation and insiders obviously has the potential for a dramatic and chilling impact on transactions with insiders tending to outrage the shareholders.

Shareholder Lists: Access Substantially the Same

Corporations statutes, including Delaware’s, typically provide shareholders with a right to inspect the list of shareholders of the corporation. This right is fundamental to the shareholder’s ability to communicate with fellow shareholders of the corporation, especially to solicit their proxy on any matter. California’s statutory coverage of this area is applicable to pseudo-foreign corporations. In general California conditions this right upon the shareholder’s having a purpose reasonably related to his interest as a shareholder. One aspect of the California statute which may present management with a greater burden than that present in other states is the unique provision that a block of at least 5 percent of the outstanding voting shares of a corporation (or 1 percent if the block has filed a Schedule 14B with the Securities Exchange Commission) has an absolute right to inspect and copy the shareholders list or to obtain from the corporation’s transfer agent, upon five days written demand and payment of the costs involved, a list of those shareholders entitled to vote.

119. A Schedule 14B must be filed by every participant in an election contest before soliciting proxies from other shareholders. The schedule requires information on the identity of each participant in the election contest, the extent of the participant's interest in the securities of the issuer and other significant information about the participant. See 17 C.F.R. § 240.14a-102 (1975).
Miscellaneous: Some Areas Where California Law May Be Beneficial to Management

To provide a balanced presentation of the burdens imposed, some additional areas of the California law applicable to pseudo-foreign corporations deserve mention. One of these is the statute delineating the standard of care for corporate directors. California's standard is the normal standard of "good faith" and "such care . . . as an ordinarily prudent person in a like position would use under similar circumstances" except that California adds the language "including reasonable inquiry" to its formulation. 121 It is possible that the addition of this phrase might be interpreted to require a director to make an inquiry regardless of the circumstances. The revision committee report clearly states, however, that there was no intention to change the usual standard and that this phrasing was added only "to make explicit . . . that reasonable care under some circumstances could include a duty of inquiry." 122 According to the drafting committee, such circumstances arise when a director "is put on notice by the presence of suspicious circumstances." 123 This section also identifies certain persons and materials on which a director may rely in performing his duties. 124

A contract or other transaction in which a director has a material financial interest is not ordinarily within the business judgment rule. A section of the California Corporation Code, however, provides that if such contract or transaction is independently and in good faith approved by a properly informed board or shareholder meeting, the decision is thereby brought under the protection of the business judgment rule. 125 Curiously, the benefits of this section are not made available to pseudo-foreign corporations. 126 But identical benefits are provided by Delaware's grant of an absolute right to obtain the shareholders list exceeds proxy rule 14a-7 under which the corporation has the option of mailing the material for the shareholder or surrendering a copy of the shareholders list. Also, rule 14a-7 does not apply unless management has made or intends to make any solicitation of proxies. 17 C.F.R. § 240. 14a-7 (1975).

122. REVISION COMMITTEE REPORT, supra note 29, at 49-50.
123. Id. at 50.
124. According to section 309(b) a director is entitled to rely on opinions or research of (1) officers and employees whom the director believes to be competent, (2) professionals, and (3) committees of the board upon which the director does not serve and which he believes to merit confidence. The section requires of the director good faith and reasonable inquiry where the circumstances warrant it. CAL. CORP. CODE § 309(b) (West Supp. 1976) (eff. Jan. 1, 1977).
125. Id. § 310.
126. This section is referred to in section 1501(b)(1) as a method of avoiding disclosure of certain inside transactions in the annual report, and presumably pseudo-foreign corporations may make use of the shareholder approval provision for that purpose. See note 115 & accompanying text supra.
ware law,\textsuperscript{127} which will serve to fill this gap.

California's unique provisions regarding corporate mergers\textsuperscript{128} and dissenters' rights\textsuperscript{129} also apply to pseudo-foreign corporations. This discussion will merely highlight those features of the California law beneficial to management which may not exist under the law of the pseudo-foreign corporation's domicile. In its revised code, California adopts "a new system for regulating corporate combinations which treats, to the extent feasible, all reorganizations . . . in the same manner so far as the requirement for shareholder approval and the existence of dissenters' rights are concerned."\textsuperscript{130} Reorganization, a new term of art in the California code, encompasses all three basic methods of corporate combination—merger, exchange, and sale of assets.\textsuperscript{131} By treating all three in the same manner, California recognizes explicitly in statute what other states have recognized only judicially under the de facto merger doctrine—that all are means to the same end.

Approval by the board of each party to a reorganization is generally required,\textsuperscript{132} while shareholder approval is only required for "acts which result in significant changes in the rights or interests of shareholders."\textsuperscript{133} Whether significant change exists is determined under what may be called a "dilution test."\textsuperscript{134} Approval of the outstanding shares of each class is required unless the corporation itself or the persons who are shareholders of the corporation before the reorganization will own, immediately after the reorganization, more than 5/6 of the equity securities of the surviving or acquiring corporation.\textsuperscript{135} In other words, if the same shareholders will still own 5/6 of the voting shares of the corporation after it combines with another, their rights have not been diluted, and they are not afforded the right to vote on whether to approve the transaction.\textsuperscript{136}

An appraisal remedy, called "dissenters' rights" in California's revised code, exists only if the shareholder had a right to vote on whether or not to approve the reorganization.\textsuperscript{137} A shareholder who

\textsuperscript{129} \textit{Id.} §§ 1300-12.
\textsuperscript{130} \textit{Revision Committee Report, supra} note 29, at 14.
\textsuperscript{132} \textit{Id.} § 1200.
\textsuperscript{133} \textit{Revision Committee Report, supra} note 29, at 93-94.
\textsuperscript{134} \textit{Id.} at 94.
\textsuperscript{136} Approval is required despite meeting the 5/6 rule if: (1) an amendment is made to the articles which would require such approval; (2) shares of a class will receive different rights, preferences, privileges, or restrictions than those surrendered; or (3) shareholders of close corporations will receive in exchange the shares of a corporation which is not closely held. \textit{Id.} §§ 1201(c), (d), (e).
\textsuperscript{137} \textit{Id.} § 1300.
can establish his shares as dissenting has a right to demand that the corporation purchase them at their fair market value as of the day before the announcement of the reorganization. To qualify his shares as dissenting, a shareholder must not have voted them in favor of the reorganization, must make a demand on the corporation for payment and must submit the shares for endorsement.\textsuperscript{138}

Dissenters' rights do not exist for shares in which there is a public market immediately prior to the reorganization, unless there is a restriction on the transfer of the shares or 5 percent of the shares of a class file a demand for payment from the corporation.\textsuperscript{139} This exception is based on the theory that a shareholder's interests are adequately protected if he can sell his shares.\textsuperscript{140} The right of 5 percent of the shares of a class to demand repurchase of their shares protects shareholders in the event that the terms of the reorganization are so unfair that the market price of the stock has plummeted.

Although appraisal remedies for some reorganizations exist statutorily in all states but one,\textsuperscript{141} the California statute may be more beneficial to pseudo-foreign corporations because California (1) includes a sale of assets in its definition of reorganization, and (2) makes dissenters' rights the shareholder's exclusive remedy in most situations. If a shareholder has dissenters' rights, then he does not have "any right at law or in equity to attack the validity of the reorganization or merger, or to have the reorganization or merger set aside or rescinded . . . ."\textsuperscript{142} The only attack that a shareholder with dissenters' rights can make is to test the legality of voting procedures.\textsuperscript{143} Thus, these sections are of obvious benefit to corporate management contemplating participation in a reorganization.

Burdens Summarized

The impact of California's law on pseudo-foreign corporations is mixed. There are several areas, notably the cumulative voting provision and the disclosure requirements where there is insider dealing, in which the California law is apt to be significantly more burdensome for

\textsuperscript{138} Id. § 1300(b).
\textsuperscript{139} Id. § 1300(b)(1).
\textsuperscript{140} See Revision Committee Report, supra note 29, at 96-97.
\textsuperscript{141} The dissenting state is West Virginia. See Model Act, supra note 22, § 81.
\textsuperscript{143} An exception exists where one corporation in the reorganization is "controlled" by another corporation in the reorganization. In such a case a shareholder in the "controlled" corporation who has not demanded payment may attack the reorganization. Id. § 1312(b). By attacking the transaction, however, the shareholder forfeits the right to demand payment for his shares.

"Control" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a corporation." Id. § 160.
pseudo-foreign corporations than their domiciliary law would be. California's law in other areas, such as the reports and records which a corporation is required to make, shareholder access to such information, and the provisions on director removal, will impose only slightly greater burdens. In still other areas corporate management may find California law more favorable than the law of the state in which they are incorporated.

Without doubt, the opportunity to avoid the application of California law by falling outside the subject group will cause management to consider whether California law should be avoided. The methods corporations will use to evaluate the overall impact of the new California law can only be a matter of conjecture. Management might balance the benefits under California law against the burdens it presents in light of its own internal variables, in which case decisions will vary with the corporation. It may be more realistic, however, to assume that management will look only to the burdens which are present under California law and which do not exist under the law of states with pro-management corporate statutes. What management will find is that the new California law contains two requirements generally disfavored by management—cumulative voting on directors and disclosure of inside dealing. Based on the presence of these alone, management easily could conclude that there is good reason to avoid the application of California law.

**Conclusion**

To prevent truly local corporations from domiciling themselves in more permissive states for the purpose of evading local law, California has enacted a new statute which applies some of its local law to foreign corporations in which California's connection to the corporation predominates over the connection of any other state or combination of states. Although not without problems, the tests under which California determines that its interest predominates are rational and functional. Many of the loopholes that appear to exist can be closed by legislative action or by a watchful judiciary. Under this system, one danger always looms in the background—the reduction of a corporation's business in California to avoid application of California law. This should not be a great danger, however, because the nature of California law will be but one factor in a corporation's decision where to do business.

California's application of its law to pseudo-foreign corporations is likely to be challenged on constitutional grounds, although apparently the similar New York law has never been so challenged. Inevitably either California law will be set up as a defense to a suit brought under

144. See Kaplan, *supra* note 1, at 449.
the law of the state of incorporation or the domiciliary law will be raised as a defense to proceedings under California law. In either event, this brings into focus the question of the effect which one state is required to give to the corporate statutes of another state under the full faith and credit clause. Once the question is raised, it is hoped that the Supreme Court will resolve it in a clear fashion to prevent justice from degenerating into a race to the most advantageous courtroom.

Certainly the 50 percent tests employed by California provide a rational means to allocate the regulation of a corporation to the state to which it is primarily related. If such a state exists, arguably it has the better claim on the power to regulate that corporation's internal affairs than does a state which the corporation itself has for convenience chosen to call home. Even if California's system were adopted nationally, not all corporations would be allocated to a single state as not all have a connection to one particular state that exceeds 50 percent on the tests enumerated. Such corporations are really more national than local. For these, it may make most sense that they be required to meet standards formulated by all the states. Perhaps it is this group to which any federal incorporation proposal should address itself. Such an allocation of the responsibility for corporate regulation would retain autonomy for the individual state where there is a legitimate claim to such autonomy, but would also allow for regulation on a national scale where there is a national interest. Congress has the Constitutional power to establish the effect the law of one state will receive in another state, and it could take the first step toward implementing such a system by legislating a conflict of laws rule based on the reasoning if not the language of California's law. Congressional establishment of a rule that the regulating state shall be the state to which a corporation is predominantly related would bring both clarity and equity to this area of the law.

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145. U.S. Const. art. IV, § 1.
146. Another ground for challenging the new statute is that it violates the constitutional prohibition of the impairment of existing contracts contained in article I, section 10 of the United States Constitution. Courts have long treated relations between a corporation and the state creating it as matters of contract. See Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819). This treatment has been extended to relations between shareholder and corporation and shareholder and shareholder. See Henn, supra note 25, at 694-99. The contract clause is not, however, an absolute prohibition, and the government is allowed to infringe on existing contract rights when reasonable. See Home Bldg. & Loan Assn. v. Blaisdell, 290 U.S. 398 (1934).
147. U.S. Const. art. IV, § 1.
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