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Focus

Law Is in Flux Over Internal Governance of Foreign Firms

By David Garcia and Erica Alterwitz

Very recently, two decisions from the 4th District Court of Appeal have used a legal principle called the "internal affairs doctrine" to reach substantially different conclusions about the appropriate impact of California law on the governance of companies headquartered in California but incorporated elsewhere, specifically in Delaware.

The doctrine requires that matters peculiar to the relationships between and among a corporation and its officers, directors and shareholders should typically be governed by the law of the state of incorporation. *State Farm Mutual Automobile Insurance Co. v. Superior Court*, 114 Cal.App.4th 434 (2003). Theoretically, the doctrine should allow for all matters involving a corporation's internal administration to be governed by the same laws, thereby insuring predictability and uniform determination of disputes.

While the internal affairs doctrine is primarily a conflict of laws principle, as described below, it also obviously has important implications for corporate governance.

In the first case, *Grosset v. Wenaas*, 133 Cal.App.4th 710 (2005), the 4th District considered two arguably open questions under California law: (1) whether a shareholder's standing to sue derivatively on the corporation's behalf is governed by the internal affairs doctrine, and (2) whether California law requires continuous ownership of stock by a shareholder derivative plaintiff throughout the litigation.

Delaware has a statute specifically requiring continuous stock ownership by derivative plaintiffs, and long-standing case law to the same effect. In considerable contrast, California has no analogous statute, and California cases have reached conflicting positions regarding the necessity of continuous ownership for derivative standing.

The shareholder plaintiff in *Grosset* brought a derivative action on behalf of a Delaware corporation headquartered in California, alleging breach of various fiduciary duties by certain of the corporation's officers and directors. The plaintiff claimed that the directors and officers of the corporation breached their fiduciary duties by allowing the corporation to be sued in a related federal securities class action, a familiar species of derivative litigation in the California Superior Court to those who litigate in this area. After dismissal of the action by the trial court, following a determination by a special litigation committee that pursuit of the derivative action was not in the company's best interest, the plaintiff sold his stock in the corporation. On appeal, the court addressed the question of plaintiff's standing to maintain the action after selling his stock.

The *Grosset* court first found that standing to bring a shareholder derivative action was, in fact, governed by the internal affairs doctrine as "an issue that concerns the relationship between a corporation and its shareholders because it is asking whether a stockholder will be allowed to maintain an action on behalf of the corporation." Because Delaware law, therefore, controlled, and Delaware law explicitly requires continuous stock ownership for standing to sue derivatively, the court held that the plaintiff had lost his standing and dismissed the appeal.

Further, the court held that even if the internal affairs doctrine did not compel application of Delaware law, in its view California law actually did require continuous ownership of stock for a plaintiff to have standing to bring a shareholder derivative action, distinguishing contrary authority.

The issue is obviously important for the governance of foreign corporations present in California, and is particularly significant in the context of challenges to mergers and acquisitions involving foreign corporations headquartered in California. It is now common for such transactions to be challenged through derivative claims attacking either the target company's board for failing to obtain a sufficiently high price or the acquiring company's directors for paying too much.

Clear appellate authority now exists exposing officers and directors of foreign corporations present in California to derivative liability under this statute even though no analogous laws exist in their own states of incorporation, including Delaware.

In Delaware, such derivative litigation ends when the merger closes and the plaintiff's ownership ceases. In California before *Grosset*, even where a Delaware company is involved, the litigation arguably could continue even though the merger has closed.

The California Supreme Court has now granted review to determine whether the question of standing to bring a shareholder derivative action is governed by the internal affairs doctrine and, even if it is not, whether California law requires continuous ownership to retain standing. The Supreme Court's determination clearly could have a significant impact on the governance of the many foreign companies doing business in California, including

those incorporated in Delaware, especially in the context of mergers-and-acquisitions litigation.

A holding that the internal affairs doctrine does not apply to the issue of derivative standing, and that California law does not require continuous stock ownership to confer standing, would significantly increase the litigation exposure to derivative actions for the directors of every foreign corporation in California. The case could also force the California Supreme Court to grapple with fundamental issues of the relationship between California procedural law and substantive Delaware corporate governance law.

In contrast to the solicitude for the internal affairs doctrine in Grosset, the same Court of Appeals gave the internal affairs doctrine a much narrower application in *Friese v. Superior Court*, 134 Cal.App.4th 693 (2005). *Friese* holds that the doctrine does not prevent officers and directors of a Delaware corporation headquartered in California from being held liable in a representative action for insider trading brought by a trustee under California Corporations Code Section 25502.5.

Section 25402 of the California Corporations Code makes it illegal for the officers and directors of corporation to trade on inside information in any securities transaction in California. Section 25502.5 then goes on to create a representative cause of action on behalf of the corporation that can be pleaded against its own officers and directors for such insider trading violations, and which provides for treble damages and attorney fees.

California is the only state with a statute creating a claim by the corporation against its officers and directors for insider trading which can be brought in a representative action.

The plaintiff in *Friese* brought suit as the corporation's trustee against the officers and directors of a bankrupt Delaware corporation headquartered in California and alleged insider trading violations. The trial court dismissed the insider trading claims, relying on the internal affairs doctrine. *Friese*.

The Court of Appeal held that the internal affairs doctrine did not prevent the plaintiff trustee from bringing claims against the directors of a Delaware corporation under Section 22502.5. The court reasoned that Section 22502.5, part of the Corporate Securities Law of 1968, was adopted as a means of protecting investor confidence in the securities market, an interest which is broader than the interests vindicated by the internal affairs doctrine.

The court saw Section 22502.5, and California's corporate securities laws in general, as a deterrent to conduct the Legislature found destructive to the public interest.

Friese thus permits derivative or representative actions against officers and directors of foreign corporations with their principal place of business in California for insider trading in California although California is the only state with a statute that specifically creates such cause of action. Clear appellate authority now exists exposing officers and directors of foreign corporations present in California to derivative liability under this statute even though no analogous laws exist in their own states of incorporation, including Delaware.

The contrast between *Grossett* and *Friese* aside, it should also be briefly observed that the refusal to apply the internal affairs doctrine in *Friese* could potentially raise constitutional issues. The internal affairs doctrine has been said to be not only a procedural conflict of laws principle but also to have constitutional underpinnings. The Delaware Supreme Court has stated that the goal of the internal affairs doctrine to ensure both that directors and officers know what law will be applied to their actions, and that stockholders know what standards of accountability they may require of their officers and directors, implicates due process concerns under the 14th Amendment. See *VantagePoint Venture Partners 1996 v. Examen Inc.*, 871 A.2d 1108 (Del. 2005).

Moreover, the Delaware Supreme Court also observed, citing long-standing U.S. Supreme Court authority, that the ultimate arbiter of any direct clash between the laws of two states potentially applicable to the same corporation must be the Commerce Clause of the U.S. Constitution. ("application of the internal affairs doctrine is mandated by constitutional principles, except in the 'rarest situations,' e.g., when the law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce.") (citations omitted).

In sum, the same solicitude exhibited by the court in *Grosset* for not applying California law to interfere in the internal affairs of a foreign corporation seems absent from its opinion in *Friese*, and now without explanation. The current holding of *Grosset* and the reasoning supporting it, certainly appear much truer to the intended purpose of the internal affairs doctrine than the analysis and result in Friese. However, the last word in *Grosset* now rests with the California Supreme Court. In any event, the exact boundaries of the internal affairs doctrine in California are currently in significant flux.

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