SIMPSON THACHER

DIRECTORS' AND OFFICERS' LIABILITY

CONFLICTING REGULATION OF INTERNAL AFFAIRS

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Many directors and officers would confidently state that their potential exposure arising out of intra-corporate matters is determined by the state law of the place of incorporation, not extra-territorial regulation. The reliability of this principle, long embodied in the internal affairs doctrine, recently has been called into question by efforts to subject the relationship among a corporation, its directors and officers and shareholders to California laws. There is now an irreconcilable conflict between the courts of the nation's most populous state and those of the preeminent state of incorporation concerning the extent of California's authority to regulate internal affairs of Delaware corporations -- an issue of great legal and practical significance to the business community -- and it is ripe for Supreme Court resolution.

Internal Affairs Doctrine

Most states, including Delaware and New York, follow the internal affairs doctrine, a choice-of-law and constitutional principle which generally requires that the laws of the state of incorporation govern "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."[1] The doctrine recognizes that interests of certainty, protection of legitimate expectations and reducing the prospect of inconsistent obligations require that only one state have the authority to regulate a corporation's internal affairs. The Restatement (Second) of Conflict of Laws describes matters that qualify as internal affairs as those "which involve primarily a corporation's relationship to its shareholders," including the election or appointment of directors and officers, the adoption of by-laws, the holding of directors' and shareholders' meetings, mergers, consolidations and reorganizations and the reclassification of shares, and the purchase and redemption by the corporation of outstanding shares of its own stock. In addition, the doctrine generally requires that the law of the state of incorporation govern allegations of director or officer breaches of fiduciary duty owed to the corporation and its shareholders.[2] When the rights of third parties unaffiliated with the corporation are at issue, however, the doctrine does not apply and ordinary choice of law

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principles govern.[3]

The doctrine's limitation on the ability of a state to encroach on the internal affairs of a corporation that has chosen to incorporate elsewhere also has a constitutional dimension. Directors and officers have a Due Process right to know in advance what law will govern their actions and shareholders "have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs."[4] In addition, as the U.S. Supreme Court held in *Edgar v. MITE Corp.*,[5] under the Commerce Clause of the U.S. Constitution a state ordinarily has no interest in regulating the internal affairs of foreign corporations. Indeed, the Commerce Clause "limits on a State's power to enact substantive legislation are similar to the limits on the jurisdiction of state courts. In either case, 'any attempt "directly" to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.'"[6]

California has most forcefully asserted control over the internal affairs of foreign corporations with significant connection to the state. Most prominently, section 2115 of the California Corporations Code purports to transform a corporation that is incorporated in another state into a "quasi-California corporation" – with the result that regardless of the state of incorporation, the foreign corporation's articles of incorporation are deemed amended to comply with California and are subject to California law -- if certain contacts with California are present. The statute applies if (i) more than one-half of the corporation's outstanding voting securities are held by persons having addresses in California (as set forth on the books of the corporation); and (ii) the average of the property factor, the payroll factor and the sales factor as defined in the California Revenue and Taxation Code is more than 50 percent during the last full income year. Eliminating any doubt about its intent, the statute expressly instructs unspecified courts to apply enumerated provisions of California's corporation law to the exclusion of any other state's laws. Section 2115 specifies the matters on which California law is to control any foreign corporation that qualifies as a "quasi-California corporation," including such core corporate governance maters as the annual election of directors, the standard of care applicable to directors, indemnification of directors and officers, and limitations on mergers. The statute exempts from its reach corporations with securities listed on the New York or American Stock Exchanges, Nasdaq, or wholly-owned subsidiaries of such corporations.

VantagePoint

Last year, in *VantagePoint Venture Partners v. Examen, Inc.*,[7] the Delaware Supreme Court ruled that, as applied to Delaware corporations, section 2115 is unconstitutional. Examen, a Delaware corporation, sought a declaratory judgment in the Delaware Court of Chancery that under Delaware law and the Company's Certificate of Designations of Series A Preferred Stock, VantagePoint was not entitled to a class vote of the Series A Preferred Stock on a proposed merger. In accordance with Delaware law and Examen's Certificate of Incorporation, the merger agreement required the affirmative vote of the holders of a majority of the issued and outstanding shares of the Common Stock and Series A Preferred Stock, voting together as a single class. VantagePoint promptly filed a competing action in California Superior Court

seeking a declaration that Examen was a quasi-California corporation under section 2115 and therefore subject to California Corporations Code § 1201(a), which would entitle VantagePoint to vote its preferred shares as a separate class in connection with the proposed merger.

Noting that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations," the Court of Chancery held on a motion for judgment on the pleadings that whether a holder of Examen's Series A Preferred Stock was entitled to a separate class vote on the merger was governed by the internal affairs doctrine because it implicated the relationship between a corporation and its stockholders. The court concluded that the inconsistency between the two states' merger vote provisions framed a choice-of-law question, and decided the case on that basis (and did not decide the constitutionality of section 2115).

Emphasizing the "constitutional imperatives" of the internal affairs doctrine, the Delaware Supreme Court affirmed. It reasoned that forcing a corporation to decide "which of two conflicting state laws govern the internal affairs of a corporation at any point in time" would foster intolerable confusion and disruption, and violate both Delaware choice-of-law principles and Constitutional Due Process, so that "VantagePoint's voting rights [must] be adjudicated exclusively in accordance with the law of its state of incorporation, . . . the law of Delaware."

VantagePoint thus provides assurance that Delaware courts will apply the DGCL to the internal corporate affairs of a Delaware corporation, and of course a decision doing so is entitled full faith and credit in any other state. Significantly, in VantagePoint Examen secured the tactical advantage of a Delaware forum before VantagePoint commenced suit in California. This enabled Examen to halt VantagePoint's efforts to obtain an expedited ruling in California on the merits of the class vote issue that was already before the Court of Chancery, by obtaining an order from the California court staying the California action pending decision in Delaware. Section 2115, however, remains on the books, and a different result is certainly possible if a "quasi California corporation" from a state other than Delaware is sued in another state that may not follow VantagePoint, or if California court deems even a Delaware corporation a "quasi California corporation" despite VantagePoint.

Friese

In Friese v. Superior Court,[8] the California Court of Appeal recently approved an extraordinarily expansive view of the reach of California law into intra-corporate matters of foreign corporations. A litigation trustee holding certain claims of Peregrine Systems, a Delaware corporation headquartered in California, alleged insider trading claims in California state court against former Peregrine directors and officers. The claims were alleged under Cal. Corp. Code § 25502.5, a statute unique to California, which authorizes a corporation itself to bring insider trading claims against its directors and officers, with damages up to three times the difference between the value of the stock with and without public knowledge of the material information. The Superior Court dismissed the claims, agreeing with defendants that

Delaware provides the exclusive law governing the relationship between a Delaware corporation and its directors. It bears emphasis that since the emergence of a comprehensive federal securities law regime which includes remedies for market participants injured by improper trading by corporate insiders, there is a lively debate as to whether Delaware corporations have a derivative claim and disgorgement remedy against corporate fiduciaries who trade on material, non-public information. The prevailing Delaware view is that "a scienter-based derivative claim is not out of step with federal law."[9]

The California Court of Appeal reversed the dismissal of the claim brought on behalf of the corporation, concluding that California's public and regulatory interests in deterring insider trading at companies operating in the state are paramount to any entity's interest in application of the internal affairs doctrine. Observing that "[t]he face of [California's insider trading statute] does not restrict its application to securities issued by domestic corporations," the court concluded that the statute's utility in "punishing what is perceived by the public as immoral conduct" authorized, "in the interest of justice," accepting jurisdiction in California over treble damage insider trading claims brought by foreign corporations against their own directors and officers. Over the dissents of two Justices, the California Supreme Court declined to review *Friese*.

Certain Peregrine former directors and officers last month filed a petition for a writ of certiorari in *Friese*. The decision raises compelling issues of great legal and practical significance to the business community, and is irreconcilably in conflict with the decision of the Delaware Supreme Court in *VantagePoint*. If a director or officer deliberately engages in insider trading, that is the essence of breach of fiduciary duty. Delaware law clearly states that any redress a corporation may have for fiduciary breaches by its own directors and officers is a classic intra-corporate matter to be determined by the law of the state of incorporation. California's expansive view of the reach of its regulatory authority thus intrudes deeply into the longstanding and legitimate province of the state of incorporation. Although advocates searching for distinctions may note that *VantagePoint* addressed a different provision of the Cal. Corp. Code than *Friese*, there is no mistaking that Delaware and California sharply differ on the extent to which the U.S. Constitution and state choice-of-law rules permit California to regulate the internal affairs of Delaware corporations.

The predictability afforded by well-defined standards of corporate governance is one of the chief inducements for businesses to incorporate in Delaware. "A state has an interest in promoting stable relationships among parties involved in the corporations it charters," the U.S. Supreme Court has noted, "as well as in ensuring that investors in such corporations have an effective voice in corporate affairs."[10] Permitting another state to exercise authority over internal corporate affairs upends these justified interests. The importance of these considerations to the stability of capital markets warrants Supreme Court review now.

1 Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).

2 Walton v. Morgan Stanley & Co., 623 F.2d 796, 798 n.3 (2d Cir. 1980).

3 McDermott, Inc. v. Lewis, 531 A.2d 206, 214-15 (Del. 1987).

4 Id. at 216-17.

5 457 U.S. 624, 640 (1982).

6 Id. at 643.

7 871 A.2d 1108 (Del. 2005).

8 36 Cal. Rptr. 3d 558 (Cal. Ct. App. 2005).

9 In re Oracle Corp., 867 A.2d 904, 932 (Del. Ch. 2004), aff'd, 872 A.2d 960 (Del. 2005).

10 CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 91 (1987).