California's Statutory Attempt to Regulate Foreign Corporations: Will It Survive the Commerce Clause

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CALIFORNIA'S STATUTORY ATTEMPT TO REGULATE FOREIGN CORPORATIONS: WILL IT SURVIVE THE COMMERCE CLAUSE?

Section 2115 of the California Corporations Code asserts control over select internal affairs of a foreign corporation if the corporation satisfies the two tests outlined in the statute. Examples of internal affairs include the election and removal of directors, method of voting for directors, and reorganizations and mergers. This Comment examines section 2115 in relation to the commerce clause of the United States Constitution. California's interests in enforcing the statute are balanced against the burdens imposed upon the free flow of interstate commerce. The author concludes that application of section 2115 excessively burdens interstate commerce and is therefore unconstitutional.

INTRODUCTION

State legislatures seeking to regulate foreign corporations doing business in their states have found regulation a difficult task. To prevent corporate desertion and to attract new corporate registrations, several states have been forced to loosen their grip on management and to pass statutes similar to Delaware's corporation law, the most lenient in the country. A consequence of emasculated corporate laws is that statutory protection of shareholders, creditors, and the public has often been sacrificed.

In defiance of the general trend toward increased management favoritism, California enacted several provisions of its General Corporation Law providing greater protection to shareholders and creditors. For example, mandatory cumulative voting, a state policy since 1878, is retained; staggered boards of directors are

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5. Id. § 708.
forbidden, annual election of directors is required, and directors may be removed without cause. The drafting committee was aware that the proposed statutory amendments contained numerous provisions for the protection of shareholders and creditors that were more restrictive than the Delaware model. A restrictive corporations code would be "largely an exercise in futility if those restrictions [could] be nullified by the simple device of incorporating or reincorporating in some other state." As a result, section 2115 of the California Corporations Code was enacted to

6. Id. § 301.
7. Id. §§ 301, 600.
8. Id. § 303.
10. Ch. 235, § 19, 1977 Cal. Stats. 1073 (codified at CAL. CORP. CODE § 2115 (West Supp. 1978)). The text of § 2115 is as follows:

(a) A foreign corporation (other than a foreign association or foreign nonprofit corporation but including a foreign parent corporation even though it does not itself transact intrastate business) is subject to this section if the average of the property factor, the payroll factor and the sales factor (as defined in Sections 25129, 25132, and 25134 of the Revenue and Taxation Code) with respect to it is more than 50 percent during its latest full income year and if more than one-half of its outstanding voting securities are held of record by persons having addresses in this state. The property factor, payroll factor and sales factor shall be those used in computing the portion of its income allocable to this state in its franchise tax return or, with respect to corporations the allocation of whose income is governed by special formulas or which are not required to file separate tax returns, which would have been so used if they were governed by such three-factor formula. The determination of these factors with respect to any parent corporation shall be made on a consolidated basis, including in a unitary computation (after elimination of intercompany transactions) the property, payroll and sales of the parent and all of its subsidiaries in which it owns directly or indirectly more than 50 percent of the outstanding shares entitled to vote for the election of directors, but deducting a percentage of such property, payroll and sales of any subsidiary equal to the percentage minority ownership, if any, in such subsidiary. For 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.

(b) 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 (annual election of directors);
- Section 303 (removal of directors without cause);
- Section 304 (removal of directors by court proceedings);
- Section 305, subdivision (c) (filing of director vacancies where less than a majority in office elected by shareholders);
- Section 309 (directors' standard of care);
- Section 316 (excluding paragraph (3) of subdivision (a) and paragraph (3) of subdivision (f) (liability of directors for unlawful distributions);
- Section 317 (indemnification of directors, officers and others);
- Sections 500 to 505, inclusive (limitations on corporate distributions in cash or property);
- Section 506 (liability of shareholder who receives unlawful distribution);
prevent foreign corporations from circumventing California law while doing business in California.\textsuperscript{11}

Corporations falling within the purview of section 2115 have traditionally been referred to as pseudo-foreign corporations.\textsuperscript{12} 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); Section 1001, subdivision (d) (limitations on sale of assets); Section 1101 (provisions following subdivision (e)) (limitations on mergers); Chapter 12 (commencing with Section 1200) (reorganizations); Chapter 13 (commencing with Section 1300) (dissenters' rights); Sections 1500 and 1501 (records and reports); Section 1508 (action by Attorney General); Chapter 16 (commencing with Section 1600) (rights of inspection).

Subdivision (a) shall become applicable to any foreign corporation only upon the first day of the first income year of the corporation commencing on or after the 30th day after the filing by it of the report pursuant to Section 2108 showing that the tests referred to in subdivision (a) have been met or on or after the entry of a final order by a court of competent jurisdiction declaring that such tests have been met. Subdivision (a) shall cease to be applicable at the end of any income year during which a report pursuant to Section 2108 shall have been filed showing that at least one of the tests referred to in subdivision (a) is not met or a final order shall have been entered by a court of competent jurisdiction declaring that one of such tests is not met, provided that such filing or order shall be ineffective if a contrary report or order shall be made or entered before the end of such income year.

This section does not apply to any corporation with outstanding securities listed on any national securities exchange certified by the Commissioner of Corporations under subdivision (o) of Section 25100, or to any corporation if all of its voting shares (other than directors' qualifying shares) are owned directly or indirectly by a corporation not subject to this section.

Only one other state, New York, has enacted a provision affecting corporate internal affairs similar to California's § 2115. N.Y. BUS. CORP. LAW § 1320 (McKinney 1953). The New York statute is applicable to foreign corporations conducting 50% or more of their business within New York State.

The North Carolina Legislature considered extending its laws to include foreign corporations in 1954; however, the provision was never adopted. 1955 N.C. Sess. Laws, ch. 1371.

Several states have statutes putting the internal affairs of a foreign corporation beyond the reach of local law, adopting a "hands-off" attitude. These states include: Alaska, ALASKA STAT. § 10.05.597 (Michie 1968); Arizona, ARIZ. REV. STAT. ANN. § 10-106 (West 1977); Illinois, ILL. REV. STAT. ch. 32, § 157.102 (West 1957); Iowa, IOWA CODE ANN. § 496A.103 (West Supp. 1978-79); Mississippi, MISS. CODE ANN. § 79-3-211 (Harrison 1973); Nebraska, NEB. REV. STAT. §§ 21-20, 105 (1977); Oregon, OR. REV. STAT. § 57.685 (1977); Pennsylvania, PA. STAT. ANN. tit. 15, § 2001 (West 1967); South Dakota, S.D. COMPILED LAWS ANN. § 47-8-3 (1969); and Virginia, VA. CODE § 13.1-102 (Michie 1978).

A "pseudo-foreign" corporation is a corporation chartered in one state but conducting business and operations entirely or in part in another state. A corpora-
tion 2115 provides for regulation by the California Corporations Code of selected internal affairs\textsuperscript{13} of a corporation domiciled in another state. When it is ascertained that (1) more than fifty percent of the average of a corporation's property,\textsuperscript{14} payroll,\textsuperscript{15} and sales\textsuperscript{16} factors are allocated to California, and (2) more than one-half of its voting securities are held of record\textsuperscript{17} by persons having an address in California, then section 2115 applies. Foreign corporations with securities listed on a national securities exchange certified by the Commissioner of Corporations are not subject to the provisions of section 2115.\textsuperscript{18}

Important constitutional issues are raised by the provisions of section 2115. Following a historical overview of California's attempts to deal with pseudo-foreign corporations, this Comment will center on the effect section 2115 has on interstate commerce and whether it conforms to the commerce clause\textsuperscript{19} of the United States Constitution. The full faith and credit,\textsuperscript{20} equal pro-

\textsuperscript{13} CAL. CORP. CODE § 2115(b) (West Supp. 1978).
\textsuperscript{14} The property factor is defined as:

\textit{[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 stage 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.}


\textsuperscript{15} The payroll factor is defined as “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.” \textit{Id.} § 25132.

\textsuperscript{16} The sales factor is defined as “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 sales of the taxpayer everywhere during the income year.” \textit{Id.} § 25134.

\textsuperscript{17} Securities known by the issuer to be held in the names of broker-dealers or nominees for broker-dealers are not considered “outstanding” for purposes of § 2115.

\textsuperscript{18} CAL. CORP. CODE § 2115(e) (West Supp. 1978). At the time of this writing only the New York and American Stock Exchanges have been certified by the Commissioner, and only corporations with securities listed on those exchanges are exempt from § 2115.

\textsuperscript{19} U.S. CONST. art. I, § 8, cl. 3. The commerce clause states: “The Congress shall have Power . . . to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes. . . .”

\textsuperscript{20} \textit{Id.} art. IV, § 1. The full faith and credit clause provides that the public acts of a state are entitled to recognition by other states. An enabling statute, 28 U.S.C. § 1738 (1976), requires that full faith and credit be given to the public acts, including statutes, of other states. Some of the factors relevant to whether the law of the state of incorporation, rather than the law of the forum state, must be applied include considerations of uniformity of application, certainty, and predictability, and the nature and intensity of the perceived state interest. Reese & Kaufman, \textit{The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit}, 58 COLUM. L.
tection,21 and contracts clauses22 of the Constitution also threaten the legality of section 2115; however, these issues are beyond the scope of this Comment.

THE TRADITIONAL APPROACH TO REGULATION OF FOREIGN CORPORATIONS

In the absence of a statute such as section 2115, courts have traditionally applied the internal affairs doctrine to regulate foreign corporations.23 This doctrine provides that the law of the forum may be applied to questions regarding the external affairs of a corporation, but the law of the state of incorporation must be applied to questions regarding internal corporate affairs.24

The internal affairs doctrine is a product of the vested rights theory of choice-of-law questions. Under this approach, the rights of a party are said to vest in the state where those rights are created. The law of that state must be applied regardless of where

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22. U.S. Const. art. I, § 10. The contracts clause of the Constitution states: "No State shall... pass any... Law impairing the Obligation of Contracts..." The right of liberty of contract is not absolute and is subject to the police power of the state. However, the power of a state legislature to limit a contractual right must always rest upon some reasonable basis and cannot be arbitrarily exercised. Ex parte Drexel, 147 Cal. 763, 82 P. 429 (1905).

The rights, duties, and obligations of the members of a corporation's board of directors are contractual in nature. San Pedro Lumber Co. v. Reynolds, 121 Cal. 74, 78-79, 53 P. 410, 410-11 (1898). A byproduct of § 2115's application is the forced abrogation of contracts with those directors whose terms have not yet expired. For example, if a director is serving a three-year term under staggered board provisions mandated by a foreign corporation's charter and bylaws, when § 2115 is applied the director's term will necessarily end at the next shareholders' meeting pursuant to California law. Cal. Corp. Code § 301 (West 1977). A corporation would be compelled to breach valid contractual agreements with its directors because such agreements may run afoul of the contracts clause.


the action is brought. Although the Supreme Court has occasionally invalidated choice-of-law decisions made by state courts, the internal affairs doctrine has never been invalidated by the Supreme Court when applied by a state to the internal affairs of a classic business corporation.

**Historical Regulation of Pseudo-Foreign Corporations in California**

**Case Law**

Several states, including California, have long entertained judicially created exceptions to the internal affairs doctrine. On several occasions California has applied its own corporation laws to the internal affairs of a foreign corporation. Early California court cases established a twofold judicial determination with respect to application of California law. First, a corporation by locating all of its property, business, and managerial operations in California was not considered truly foreign. Second, the plaintiff had to be a California resident in need of relief which would be denied if the internal affairs doctrine were applied.

Following World War II, the developing California policy with respect to pseudo-foreign corporations focused on securities regulation rather than on case law. The California Commissioner of Corporations exercised control over pseudo-foreign corporations by regulating any securities transactions affecting California shareholders of the corporation.

In 1961, the Commissioner's regulatory power was tested in the

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27. For examples of significant cases in states other than California where the internal affairs doctrine has been judicially circumvented, see *Mansfield Lumber Co. v. Johnson*, 263 F.2d 748 (5th Cir. 1959); *Weede v. Iowa S. Util. Co.*, 231 Iowa 784, 2 N.W.2d 372 (1942); *German-American Coffee Co. v. Diehl*, 216 N.Y. 57, 109 N.E. 875 (1915).


Big Jim Mines was an Arizona corporation. Because its principal place of business, its corporate books and records, and the mining interest owned by the corporation were all located entirely within California, the corporation was rendered subject to California laws governing internal corporate affairs.

leading case of Western Airlines, Inc. v. Sobieski.31 Western Airlines, a Delaware corporation, conducted a substantial amount of business in California. Approximately thirty percent of the company’s shares were held by California residents.32 Western Airlines sought a charter amendment to eliminate cumulative voting, a lawful change in Delaware but not in California.33 The California Commissioner of Corporations contended that the proposed change was a “sale” under California law and thus subject to his approval.34 Upon application for this approval, Western Airlines was denied a permit on the ground that the proposed change was unfair.35 Western Airlines appealed the ruling, arguing that the sale would occur primarily outside California. In upholding the Commissioner’s action, the California appellate court emphasized that Western Airlines conducted a substantial amount of business in California36 and stated, “Unless it can be said that the Corporation Commissioner’s characterization of such corporation as ‘pseudo-foreign’ is arbitrary, it would appear to be a matter well within his administrative discretion.”37

The Western Airlines decision caused considerable confusion among corporate planners. Although courts in earlier cases had exercised control over pseudo-foreign corporations that did nearly all of their business in California, Western Airlines applied California law to a foreign corporation with only thirty percent of its shareholders residing in California and having only a substantial portion of its business conducted within the state.38 The Western Airlines decision caused considerable confusion among corporate planners. Although courts in earlier cases had exercised control over pseudo-foreign corporations that did nearly all of their business in California, Western Airlines applied California law to a foreign corporation with only thirty percent of its shareholders residing in California and having only a substantial portion of its business conducted within the state.38

32. Id. at 402, 12 Cal. Rptr. at 721.
34. Qualification is the process of submitting for approval to the California Commissioner of Corporations information about a proposed sale or exchange of securities. Without the Commissioner’s approval, a sale or exchange of securities offered to the public cannot take place lawfully. See generally Cal. Corp. Code §§ 25100-25160 (West 1977).
35. Western Airlines, Inc. v. Sobieski, 191 Cal. App. 2d 399, 401-03, 12 Cal. Rptr. 719, 720-22 (1961). Under California securities law a permit may be denied on the grounds that is is not “just and fair.” This is in sharp contrast to federal regulations which require only an adequate level of disclosure.
36. Id. at 402, 12 Cal. Rptr. at 721.
37. Id. at 412, 12 Cal. Rptr. at 727.
Airlines decision clearly broadened the concept of a pseudo-foreign corporation.

Attempts at Statutory Regulation

Following Western Airlines, corporate management called upon the California Legislature for more definite and precise criteria to indicate when California law would be applied to a foreign corporation. The California Corporate Securities Law of 1968 established a definitive test. Section 25103 prohibited the Commissioner from asserting jurisdiction over any foreign corporation unless at least twenty-five percent of the corporation's shares were held by persons having California addresses. The shareholder residency test, supplanting earlier judicial and administrative guidelines, became the sole determinative factor respecting the applicability of California securities regulations to foreign corporations. This test remained the controlling guideline until the enactment of section 2115 as part of the 1975 revisions to the General Corporation Law.

Corporate Efforts to Avoid Application of Section 2115

Because section 2115 mandates significant changes in established corporate internal operations, foreign corporations will probably attempt to avoid application of section 2115. These efforts will take three forms: (1) the use of subdivision (e), which exempts corporations listed on certain national securities exchanges; (2) artificial attempts to reduce California's interests, as computed in either of section 2115's tests of applicability; and (3) actual reduction of California contacts.

state other than California, which conducted all of its business operations in California.

40. CAL. CORP. CODE § 25103 (West 1977).
41. Ch. 235, § 19, 1977 Cal. Stats. 1073 (codified at CAL. CORP. CODE § 2115 (West Supp. 1978)). The inadequacies of § 25103 became apparent in the years following its enactment. The private placement offering, CAL. CORP. CODE § 25102(a) (West 1976), permits a nonpublic sale of securities to fewer than 11 people without obtaining an issuance certificate from the Commissioner of Corporations, thereby completely avoiding his regulatory power. In 1975 there were 1,350 private placement offering qualification applications filed, and the trend is increasing. At least 135 of the applications came from foreign corporations. DEPARTMENT OF CORPORATIONS QUALIFICATIONS AND REGISTRATION DIVISION, STATE OF CALIFORNIA, REPORT OF ACTIVITIES FOR THE STATE (1975).
42. Most significant of the changes in internal operations required by § 2115 are annual election of directors, removal of directors without cause, and cumulative voting for election of directors. For a complete listing and cross reference to controlling California code sections, see CAL. CORP. CODE § 2115(b), note 10 supra.
43. See text accompanying notes 14-18 supra.
Subdivision (e) exempts corporations listed on national securities exchanges certified by the California Commissioner of Corporations. The theory behind this exemption is that federal securities regulations provide protection for investors equivalent to that provided under California law. Federal securities regulations do not, however, deal with some of the internal affairs addressed by section 2115.44 Federal securities regulations focus on assuring adequate disclosure of relevant facts regarding a securities issuer.45 California's Corporation Law seeks not only adequate disclosure, but fair, just, and equitable corporate proceedings.46

Artificial attempts to circumvent application of section 2115 will focus on the number of outstanding shares held by persons with a California address. For example, an address change established through a voting trust in another state will exempt those shares registered under the trustee's foreign address from the provisions of section 2115. Actual reduction of a corporation's contacts with California will take place by a reduction of business transacted in California, movement of plants and facilities out of the state, or in the rare extreme, inducing shareholders of major blocks of securities to physically move from California to another state.

The application of section 2115 to foreign corporations raises several questions of a constitutional nature. Foremost among these considerations are challenges based upon the commerce clause of the United States Constitution.47

COMMERCE CLAUSE BACKGROUND AND TRADITIONAL COURT TESTS

The commerce clause has frequently been held to limit the application of state law to interstate situations.48 The primary rea-
son for enactment of the commerce clause was the mutual jealousies and aggressions of the states, expressed in the form of customs barriers and other economic retaliation.\textsuperscript{49} The Madisonian interpretation of the commerce clause was premised on a widely held opinion that the Articles of Confederation had failed in large part because the states had waged destructive trade wars against one another and that state governments had been overly responsive to local economic interests.\textsuperscript{50} As a result, discriminatory, self-protective, and retaliatory state actions were occasioned by the state governments' tendency to pursue their separate interests at the expense of one another.\textsuperscript{51} The commerce clause was designed to remedy this economic isolationism by giving Congress the power to regulate commerce among the states.\textsuperscript{52}

Courts have employed various tests in attempting to determine when state legislation violates the commerce clause.\textsuperscript{53} Two landmark United States Supreme Court decisions, \textit{Southern Pacific Co. v. Arizona}\textsuperscript{54} and \textit{Bibb v. Navajo Freight Lines, Inc.}\textsuperscript{55} address the problems created by conflicting state legislation which affects interstate commerce.

In \textit{Southern Pacific}, Arizona had declared unlawful the operation in Arizona of a railroad train exceeding a specified length. Adherence to the provision necessitated breaking up long trains before they entered Arizona and reassembling them after they left. The Supreme Court did not challenge Arizona's authority to make laws governing matters of local concern.\textsuperscript{56} However, in invalidating the statute as violative of the commerce clause, the Court reasoned that Arizona’s interest failed to outweigh the na-

\begin{footnotesize}
\textsuperscript{50} Id. at 478.
\textsuperscript{51} L. TRIBE, AMERICAN CONSTITUTIONAL LAW § 6-3, at 321 (1978).
\textsuperscript{52} In January of 1786, the General Assembly of Virginia, which ultimately produced the United States Constitution, initially gathered the states together solely “to take into consideration the trade of the United States; to examine the relative situation and trade of the said states; to consider how far a uniform system in their commercial regulations may be necessary to their common interest and their permanent harmony.” H.R. Doc. No. 398, 69th Cong., 1st Sess. 38 (1927).
\textsuperscript{53} See, e.g., United States v. E.C. Knight Co., 156 U.S. 1 (1895) (Court focused on whether a state's action had a \textit{direct} impact on interstate commerce and was thus invalid, or whether the effect was \textit{indirect} only and permissible); Cooley v. Board of Wardens, 53 U.S. (12 How.) 299 (1851) (Court distinguished those aspects of commerce so \textit{local} in character as to allow state regulation from those aspects of interstate commerce so \textit{national} in character as to require a single uniform rule to be supplied by Congress).
\textsuperscript{54} 325 U.S. 761 (1945).
\textsuperscript{55} 339 U.S. 520 (1959).
\textsuperscript{56} 325 U.S. 761, 767 (1945); see California v. Thompson, 313 U.S. 109, 113-14 (1941); South Carolina Highway Dep't v. Barnwell Bros., Inc., 303 U.S. 177, 187-96 (1938); Minnesota Rate Cases, 230 U.S. 352, 399-400 (1913).
\end{footnotesize}
tional interest in keeping interstate commerce free from overly burdensome interferences.\textsuperscript{57}

In \textit{Bibb}, Illinois had enacted a safety measure specifying a particular type of mudguard for trucks operating on Illinois highways. The mudguard required by Illinois was different from that permitted in at least forty-five other states and it was illegal in Arkansas. Finding a need for national uniformity of regulation, the Court struck down the Illinois statute because of its adverse effect on interstate commerce.\textsuperscript{58}

Both the \textit{Southern Pacific} and \textit{Bibb} Courts employed a balancing test, weighing state interests against the benefits of national uniformity. Legislation aimed at furthering public health or safety or at restraining fraudulent or otherwise unfair trade practices is less likely to be seen as an undue burden on interstate commerce than are, for example, state regulations seeking to maximize the profits of local businesses.\textsuperscript{59} Under the balancing test, a state may, in the proper exercise of its police power, enact statutes which will affect interstate commerce, provided the effect is only incidental.\textsuperscript{60}

The balancing test fostered by the \textit{Southern Pacific} and \textit{Bibb} Courts was given further dimension in \textit{Pike v. Bruce Church, Inc.}\textsuperscript{61} In \textit{Pike}, the United States Supreme Court struck down an Arizona statute that required cantaloupes grown in-state to be processed in-state. The Court found that the sole purpose of the act was to boost the state’s agricultural reputation, and the Court enunciated the current standard for determining whether a statute violates the commerce clause:

Where the statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only \textit{incidental}, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. . . . If a legitimate local purpose is found, then the question becomes one of \textit{degree}. And the extent of the burden that will be tolerated will of course depend on the

\textsuperscript{57} 325 U.S. 761, 776 (1945).
nature of the local interest involved, and on whether it could be promoted as well with lesser impact on interstate activities.63

Application of the *Pike* test to section 2115 would require that four standards be met: (1) there must be a legitimate local public interest;64 (2) there must be only an incidental effect on interstate commerce; (3) the effect must not be excessive in relation to the purported local benefits; and (4) the statute must regulate evenhandedly.65 Section 2115 violates the commerce clause when examined according to the *Pike* criteria.

**APPLICATION OF THE PIKE TEST TO SECTION 2115**

**A Legitimate Local Public Interest**

Although the authority to regulate interstate commerce is expressly given to Congress by the United States Constitution,66 a state, through exercise of its police power, may regulate items affecting interstate commerce if necessary for preservation of the safety, health, comfort, morals, or general welfare of its citizens.67 Section 2115 was enacted pursuant to California's police power primarily to protect California creditors and shareholders from fraud and unfair corporate practices.68 This protection is a valid exercise of the state's police power.69 A corporation conducting business in California necessarily affects the interests of some segment of the public. Any person or corporation engaging in

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63. Id. at 142 (citations omitted) (emphasis added).

64. The terms "local interest" and "local public interest" refer to the state and may be used interchangeably in this context with "state interest."

65. See also Huron Portland Cement Co. v. City of Detroit, 362 U.S. 440, 443 (1960).


67. Under the American constitutional system, police power is left to the states by virtue of their general sovereignty. Each state has the power to regulate the relative rights and duties of all persons, individuals, and corporations within its jurisdiction for the public convenience and the public good. The only limit to state exercise of power in the enactment of police laws is that the laws cannot be repugnant to the provisions of the state or national constitutions. See generally *Hammer v. Dagenhart*, 247 U.S. 251, 275 (1918), overruled on other grounds in *United States v. Darby*, 312 U.S. 100, 116-17 (1941); *In re Rameriz*, 193 Cal. 633, 226 P. 914 (1924); Gaylon v. Municipal Court, 229 Cal. App. 2d 657, 40 Cal. Rptr. 446 (1964); People v. Cordero, 50 Cal. App. 2d 146, 122 P.2d 648 (1942); 16 AM. JUR. 2d *Constitutional Law § 274* (1964); 13 CAL. JUR. 3d *Constitutional Law §§ 117-154* (1974).

68. The 1975 Legislative Committee Comment of the California Assembly to the proposed § 2115 states that the section will apply to any foreign corporation "with specified minimum contacts in this state . . . for the protection of California creditors and shareholders." CAL. CORP. CODE § 2115, Legislative Committee Comment (West 1977) (following cited code section) (emphasis added).

business in California is subject to reasonable regulations to protect public welfare.

However, it is difficult to understand why California so diligently strives to protect creditor interests. Creditors are not coerced to transact business or to develop contacts with any corporate entity. Debtor-creditor transactions are usually business dealings at arm's length. Creditor protection should arise from self-initiated industry regulation, legal counsel, and contractual provisions.

The legitimate goal of shareholder protection is furthered by section 2115. Certain internal affairs as regulated by section 2115 offer greater benefits of stock ownership to minority shareholders than allowed by many states. For example, cumulative voting safeguards minority representation on a corporation's board of directors.\(^1\) In order to preserve the benefit of cumulative voting, all of the directors must be voted for at one time.\(^1\) For this reason, annual election of all directors is mandated by section 2115.

Although protection of shareholders is a valid exercise of California's police power, the protections assured by section 2115 are excessive. The California Legislature, through enactment of this section, has rejected provisions such as straight one-vote-per-share voting and staggered election of directors, which other states have determined are adequate to protect the public welfare. Although California's police power interest is well established, even a legitimate state interest cannot justify a statute having overly burdensome effects on interstate commerce.

In incidental effect on interstate commerce not excessive in relation to the purported local benefits

When a state legislates a provision such as section 2115, the statute must be examined to ascertain whether it places an undue burden on the free flow of interstate commerce.\(^2\) Uniformity of

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70. Cumulative voting allows a shareholder to cumulate his votes at an election for directors and give one candidate a number of votes equal to the number of directors to be elected, multiplied by the number of votes to which the shareholder's shares are entitled. The effect is to allow minority shareholders the opportunity to elect representation on the board of directors.


corporate internal affairs is necessary to assure corporate management certainty in its dealings. The internal affairs doctrine offers certainty by consistently applying the law of the incorporating state. There can be no uncertainty in identifying the state of incorporation.

For many corporations, it is highly desirable to incorporate in a state with a large body of case law interpreting corporate statutes, thus affording greater certainty of statutory interpretation. Many corporations are attracted to Delaware because of Delaware's enormous body of case law. Thus, companies that incorporate in Delaware know precisely what they can or cannot do in almost any circumstance. Attempting to supersede established law of the state of incorporation with local law could culminate and has culminated in confrontation between conflicting state laws. Increased confrontation will ultimately lead to increased litigation. A chaotic condition will result if the regulations pertaining to corporate internal affairs are continually subject to fluctuation.

The most unstable aspect of section 2115 is subsection (d). This subsection provides that section 2115 shall cease to be applicable at the end of any income year in which either the average of payroll, property, and sales attributable to California falls below fifty percent, or less than half of the shares outstanding are held by shareholders with a California address. The applicability of section 2115 to a foreign corporation is determined annually, pursuant to information supplied each year by the corporation to the California Franchise Tax Board. Thus, the entire internal structure of a corporation, including election and removal of directors, method of voting for directors, inspection of records and reports, and reorganizations and mergers, could potentially be controlled by a different state law each year.

Because a business in its infancy is normally unstable, application of section 2115(d) could be particularly damaging to a newly formed corporation. A new corporation might find that the amount of business transacted in a state rapidly fluctuates because of expansion to other states. Additional stock offerings could significantly change the percentage of stock attributable to

75. Id.
76. See Great W. United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978). "Local law" as used here refers to the law of a state, other than the state of incorporation, in which a foreign corporation conducts business.
shareholders having a California address. Section 2115(d) and its annual application test pose a serious impediment to a new corporation's growth. Applications of section 2115 could foster corporate relocations, remove the incentive to expand business, and, in some instances, even cause a reduction of business in California. A corporation might, by choice or necessity, take extensive measures to avoid the application of California law. The corporation could thereby impede its growth by directing attention to matters other than the conduct of business.

A corporation placed in such a quandary could lose business opportunities by appearing confused and uncertain to potential as well as established customers. Opportunities could be overlooked simply because the corporation's board of directors is preoccupied with the question of whether it still legally constitutes the board. In today's business climate, a decision or failure to make a decision by one corporation is felt by many, including suppliers, distributors, parts manufacturers, advertisers, and retail outlets. The cumulative effect in all those areas is far more than an incidental impact on commerce. The interference with interstate commerce occasioned by section 2115 is excessive in relation to the purported local benefits.

Section 2115’s impact on interstate commerce was brought into focus in a recent California superior court case, *Louart v. Arden-Mayfair*. Arden-Mayfair was a Delaware corporation with principal executive offices in California. Arden-Mayfair's primary business was the operation of a chain of supermarkets in five western states, including California. Arden-Mayfair had almost 12,000 shareholders located in every state of the United States, yet Arden-Mayfair was within the purview of section 2115 because sixty percent of the company's payroll, property, and sales were attributable to California, and approximately sixty-seven percent of issued securities were held by persons with California addresses. Pursuant to authority granted by Delaware's General Corporations Law, Arden-Mayfair's bylaws provided for straight

78. Civ. No. C-192-091 (Super. Ct. of Los Angeles County, May 1, 1978). *Louart* will have major ramifications in the business community and may become a landmark case in California corporation law history. Though decided only at the superior court level as of this writing, the case is cited in 1A Ballantine & Sterling, California Corporation Laws § 393.04, ch. 18-41 n.20.1 (4th ed. 1978), and California law professors have discussed the *Louart* decision with classes in corporation law.
one-vote-per-share voting of capital stock and a "classified" or staggered board of directors to serve one- to three-year terms.

Louart, a California corporation and the principal shareholder of Arden-Mayfair, brought an action under section 2115 for a writ of mandamus to compel Arden-Mayfair to comply with California corporate law provisions requiring annual election of all directors and mandatory cumulation of votes for the directors' election. A California superior court, in ruling for Arden-Mayfair, found that if section 2115 were applied to Arden-Mayfair it would "impact and unduly burden Arden-Mayfair's transaction of business in interstate commerce." The court anticipated that power struggles and manipulations might take place if section 2115 were applied. For example, under section 2115's mandate for single election of all directors by cumulative voting, Louart would be able to elect a majority of the board, thereby making itself incumbent management. Louart could then manipulate the ownership factor of the number of shares held by persons with a California address to less than fifty percent. The Delaware charter and by-laws would be resuscitated, section 2115 would no longer control, and the previous structure, complete with staggered terms and straight voting, would preserve Louart's management domination.

The court believed that application of section 2115 would "subject Arden-Mayfair to the hazard of potentially conflicting claims of shareholders . . . [and] to the hovering and continuing uncertainty with respect to matters which are central to its internal governance in that California statutes purport to displace the laws of Delaware." Relying on the commerce clause, the court invalidated the application of section 2115 to Arden-Mayfair. The court reasoned that otherwise legitimate interests of each state must yield when a burden would be placed on interstate commerce if every state with an interest were to apply its own law.

The interaction of section 2115 with similar laws of other states

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80. Id. § 141(d).
82. Id. § 708(a)-(c) (West Supp. 1978).
84. For examples of how Louart might accomplish manipulation of the stock ownership factor, see text accompanying notes 41-47 supra.
86. Id. at 16.
87. Id. at 21 (quoting Horowitz, The Commerce Clause as a Limitation on State Choice-of-Law Doctrine, 84 Harv. L. Rev. 806, 808 (1971)).
could place an additional burden on interstate commerce. California has chosen a two-pronged test to determine when California law applies to a foreign corporation's internal affairs. One test relates to the average of payroll, property, and sales; the other test concerns the addresses of securities holders. Has California utilized the proper tests or employed all the necessary criteria? Another state might enact the same controls using different criteria embodied in a more demanding or less demanding test. A corporation doing business in several states, each state with its own test and regulatory scheme, would be reduced to chaos. Litigation involving which state law to apply would be monumental, as would litigation over the actual factual determinations.

Under California's Corporation Law, a corporation failing to comply with section 2115 is liable for misdemeanor sanctions in the form of a fine of not less than $500 or greater than $1,000. A court of equity can mandate compliance, enforceable by the threat of contempt. Other states might also have sanctions. Corporate directors would spend excessive amounts of time seeking to avoid a state's penalties. A recent case, Great Western United Corp. v. Kidwell, involving Idaho's corporate takeover law, is illustrative of the conflict presented when several states seek to control a subject area requiring uniform regulation.

Great Western, a 1978 Fifth Circuit Court of Appeals decision, invalidated Idaho's corporate takeover statute under the commerce clause. Great Western, a Delaware corporation with headquarters in Texas, initiated a takeover of Sunshine Mining and Metal Company, a Washington corporation with its principal executive office and over fifty percent of its assets in Idaho and shareholders throughout the United States.

Idaho's takeover law subjected Great Western to stricter regulations and disclosure requirements than the Federal Securities Exchange Act of 1934 governing corporate tender offers. Because

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88. For a recent Fifth Circuit Court of Appeals decision in which the threat of multiple litigation caused considerable confusion, see Great W. United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978), and text accompanying notes 87 supra and 89-95 infra.
89. CAL. CORP. CODE § 2258 (West 1977).
90. See text accompanying notes 48-52 supra.
91. 577 F.2d 1256 (5th Cir. 1978).
93. 15 U.S.C. §§ 78j(l), 78m(d)-(e), 78n(d)-(f) (1976). These code sections, taken together, are commonly referred to as the Williams Act.
the target company owned subsidiary manufacturing facilities in Maryland and conducted significant business activities in New York, Great Western was faced with the problem of meeting the requirements of three states' takeover statutes. Compliance with the statutes would have required Great Western to wait for New York and Maryland to rule on the applicability of their laws and to wait for an Idaho hearing and judicial review procedure. Great Western chose, instead, to sue the officials of New York, Maryland, and Idaho who were responsible for enforcing the takeover laws. Maryland chose not to assert jurisdiction and New York later relinquished any interest in the matter, leaving Great Western to contend with only the Idaho statute. The district court found Idaho's takeover statute an unconstitutional burden on interstate commerce.

On appeal, the Fifth Circuit Court of Appeals considered Idaho's primary interest in enacting its takeover statute. Two major purposes were noted: investor protection and the state's interest in benevolent corporate management. The court concluded that even though the interests served by Idaho's takeover statute were legitimate local interests, they did not justify the law's substantial impact on interstate commerce. Not only did the statute tend to assist some shareholders while hindering others, but the statute also hindered movement of local businesses to other states.

Although Great Western involved a state's takeover law rather than a statute asserting control over a foreign corporation as does California's section 2115, the case is illustrative of several enduring problems. When multiple states either assert the power to regulate or have the statutory authority to do so—as did Idaho, Maryland, and New York in Great Western—the corporation is placed in a confusing position. Great Western had to resort to litigation over the matter at tremendous expense and waste of time. The true purpose of Idaho's takeover statute was to protect investors, much as section 2115's purpose is shareholder and creditor protection. Granted the legitimacy of this purpose, application of the Idaho takeover statute not only interfered with commerce but actually blocked over $31 million of interstate commerce by delaying an interstate tender offer that otherwise would have gone forward. Idaho's provision sought to regulate a corporate activity

95. Id. at 1264.
96. Id. at 1283.
97. Id. at 1285.
98. Id. at 1286.
99. Id.
affecting internal affairs. Similarly, section 2115 mandates regulation of the internal operations and structure of a foreign corporation.

The Cumulative Effect

Although one regulated corporation, viewed alone, may not appear to have a great effect on trade among the states, the courts have historically paid particular attention to the cumulative effects of a statute on the free flow of commerce. In Wickard v. Filburn, the United States Supreme Court found that because a small amount of wheat grown by a farmer for private consumption competed with wheat in commerce, the wheat was subject to federal agricultural production regulations. The Court reasoned that although the amount of the defendant's home-grown wheat was insignificant, when added to the home-grown wheat raised by many others, the cumulative effect was far from trivial.

This cumulative effect concept has been stated as follows: "[R]egulations that individually seem only local in impact can collectively burden multi-state enterprises to such a degree that all will be barred by the negative implications of the commerce clause." Hundreds of corporations, if confused with respect to their internal affairs, could significantly impede the flow of commerce.

The Statute Must Regulate Evenhandedly

The Constitutional Guarantee of Equal Protection of the Laws

Fundamental to examining any government legislation is the United States constitutional guarantee of equal protection of the laws. Any government discrimination must be tested against

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102. Id. at 128.
103. Id. at 127-28.
105. The provision found in § 1 of the 14th amendment guaranteeing equal protection reads as follows: "[N]or shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdic-
the fundamental requirements of the equal protection clause.

A corporation is considered a domiciliary and a "person" of its incorporating state.106 Governmental action may deprive a person of equal protection of the laws by two methods. First, equality is denied when a government discriminates between persons who should be regarded as similarly situated.107 If a corporation's securities are traded on a national securities exchange certified by the California Commissioner of Corporations, section 2115(e) exempts that corporation from mandatory compliance.108 The required certification is predicated on federal requirements wholly unrelated to California's purpose of shareholder and creditor protection in enacting section 2115.

Companies listed on a certified national securities exchange need not provide some of the shareholder protections, such as cumulative voting rights and annual election of directors, required of unlisted companies through application of section 2115. A statutory discrimination, if allowed to exist, must be based on differences that are reasonably related to the purpose of the statute so that all persons similarly circumstanced shall be treated alike.109 Section 2115, by exempting companies listed on certified national securities exchanges, has created a select class of exempted corporations based on criteria bearing no reasonable relationship to the statutory goals of shareholder and creditor protection.110 The type of discrimination permitted by section 2115(e) cannot be justified under the equal protection clause.

A second circumstance in which equal protection is denied occurs when government fails to classify, with the result that regulations do not distinguish between persons who should be regarded as differently situated.111 Section 2115 treats corporations having substantial interstate operations and shareholders scattered across the country the same way it treats "tramp" corporations. Tramp corporations are those doing all of their busi-

108. CAL. CORP. CODE § 2115(e) (West Supp. 1978). As of this writing, only those corporations having securities listed on the New York or American Stock Exchanges are allowed to claim this exemption.
110. See text accompanying notes 66-71 supra.
ness in California though incorporated elsewhere, in contrast to foreign corporations engaged in extensive interstate business. The California legislature should regulate "tramp" and multistate pseudo-foreign corporations differently. A failure to make this distinction in treatment of foreign corporations renders the statute violative of the equal protection clause.

RECOMMENDATIONS FOR CHANGE

Federal Intervention

Uniformity of corporate regulation, if desired, must be provided by the federal government, not by the states. Several commentators have proposed various degrees of federal regulation. The demand for more federal corporate law has come largely from those who feel that the current state-oriented system of regulating national interstate corporations is inadequate and often corrupt.

The proposals fall into two categories: a comprehensive federal corporation act preempting the individual state laws and federal guidelines establishing minimum standards of corporate responsibility applicable to all states. Under a comprehensive federal corporate law, choice-of-law questions concerning internal corporate affairs would cease to be an issue. State regulation would terminate and be replaced by exclusive federal chartering.

A more feasible solution would be to establish minimum federal corporation law provisions applicable to companies doing business in interstate commerce. To insure that the provisions would be uniformly interpreted, questions concerning the code would require exclusive jurisdiction of the federal courts. Perhaps a

115. One recognized authority in corporate law, William L. Cary, has viewed federal incorporation as politically unrealistic. Although the idea has been raised many times in Congress, Professor Cary believes American business would unanimously reject such a proposal. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 700 (1974).
number of special federal corporate forums could be established to adjudicate questions arising under this new federal law. In effect, this solution would continue to allow companies to incorporate in the jurisdiction of their choice, but many of the incentives to organize in states with lenient, pro-management laws would be eliminated.

California Action

In the absence of federal regulation, California would be prudent either to revise section 2115 or to abolish it altogether. Either choice should attempt to bring treatment of foreign corporations doing business in California within the ambit of the United States Constitution.

California's legislature erred in attempting to codify control over the internal affairs of foreign corporations. Prior to the enactment of section 2115, California courts had been effectively regulating the same foreign corporations through judicially recognized exceptions to the internal affairs doctrine. The repeal of section 2115 would allow a return to judicial determination on an ad hoc basis and to the less definitive, yet less constitutionally offensive, test of "substantial business contacts."117

Alternatively, section 2115's tests of applicability should be modified. The current "one half" test could be replaced by a "substantial amount" standard, placing greater emphasis upon the particular facts of each case.

Subdivisions (c) and (d), providing for annual determination of section 2115's applicability, should be abandoned. A corporation cannot build a business upon a foundation of annually fluctuating internal operations.

Conclusion

Section 2115, although enacted as a good faith attempt by the California legislature to protect shareholders and creditors, seriously conflicts with the commerce clause and other United States constitutional provisions. A corporation's attempt to comply with section 2115 could result in internal confusion, with an ultimate loss of business opportunities. Efforts to avoid application of section 2115 might result in corporate relocations, movement of plants and facilities to out-of-state locations, and rejection of new business. Suppliers and dependent businesses would be affected. Section 2115's yearly determination of applicability might drasti-

116. See notes 27-37 and accompanying text supra.
117. See text accompanying notes 31-36 supra.
cally increase litigation, create struggles for control among the
states, and create confusion as to which state law should apply.
The effects would be particularly devastating to fluctuating, rap-
idly expanding new businesses. All of these difficulties have far
more than an incidental effect on interstate commerce.

In the absence of federal legislation regulating corporate inter-
nal affairs, choice-of-law decisions should remain the subject of
judicial determination on an ad hoc basis. The California Legisla-
ture should seriously consider repeal or modification of section
2115.

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