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PERSPECTIVE

'Internal affairs': an elusive doctrine

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Companies operating in California are often incorporated out of state. If a foreign company or its directors or officers are sued in California, a threshold question is often which state's laws apply to the specific claims asserted. The "internal affairs doctrine" is a conflict of laws principle holding that only the state of incorporation should regulate a corporation's internal affairs. And if — pursuant to the internal affairs doctrine — the incorporating state's laws apply (e.g., Delaware law), the result may be very different than what one might expect under California law.

For instance, under Delaware law, an oral promise to issue stock or stock options is unenforceable unless it is evidenced by a writing and "approved by the Board of Directors." Del. Code Section 157(a); see also *Patriot Scientific Corp. v. Korodi,* 504 F. Supp. 2d 952 (S.D. Cal. 2007) (court applied Delaware law to dismiss the employee claim that he was orally promised stock options because said promise was not evidenced by a writing or approved by the foreign corporation's board of directors). As another example, unlike other jurisdictions (including Delaware), California law does not extend the business judgment rule protection to officers of a corporation. See *FDIC v. Perry,* No. CV 11-5561 (C.D. Cal. Feb. 21, 2012), *leave to appeal denied* (May 11, 2012). Thus, in these examples, an employer would want the protection offered under Delaware law to apply under the internal affairs doctrine.

The doctrine and its limits

Under the internal affairs doctrine, the law of the state of incorporation should govern "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders — because otherwise incorporation could be faced with conflicting demands." *State Farm Mut. Auto. Ins. Co. v. Superior Court,* 114 Cal. App. 4th 434, 442 (2003) (citing *Edgar v. MITE Corp.,* 457 U.S. 624, 645 (1982)). "States normally look to the state of a business' incorporation for the law that provides the relevant corporate governance general standard of care." *Vaughn v. LJ International, Inc.,* 174 Cal. App. 4th 213, 223 (2009) (citing *Atherton v. FDIC*, 519 U.S. 213, 224 (1997)).

It is well-settled that the internal affairs doctrine applies to matters relating to a corporation's structure and internal administration, such as "steps taken in the course of the original incorporation, the election or appointment of directors and officers, the adoption of bylaws, the issuance of corporate shares, preemptive rights, the holding of directors' and shareholders' meetings, methods of voting ... mergers, consolidations and reorganization and the reclassification of shares." *Lidow v. Superior Court,* 206 Cal. App. 4th 351, 359 (2012) (citing Rest.2d Conf. of Laws, Section 302, com. A, p. 307). In fact, California has partially codified the internal affairs doctrine. See Cal. Corp. Code Section 2116 (directors of foreign corporations doing business in California are liable according to the laws of the state of incorporation for unauthorized dividends, share purchases or asset distributions, false certificates, reports, or public notices, and "other violation of official duty").

However, the internal affairs doctrine can apply more broadly to alleged contracts or employment-type relationships with officers or employees of a foreign corporation. See *State Farm*, 114 Cal. App. 4th at 446 ("[t]he law applicable to a contract dispute ... does not control claims relating to the internal affairs of the corporation."); *In re Verisign, Inc., Derivative Litig.*, 531 F. Supp. 2d 1173, 1215 (N.D. Cal. 2007) (foreign law may apply to "claims for breach of fiduciary duty, accounting, unjust enrichment, rescission, constructive fraud, corporate waste, breach of contract, gross mismanagement, and restitution"). The impact of the internal affairs doctrine is limited only by the potential variance of relevant incorporating state's laws compared to California's.

There is still significant uncertainty regarding the scope of the internal affairs doctrine. First, under California law there is a key statutory exception to the internal affairs doctrine that applies if: (1) more than half the corporation's voting stock is held by California residents; and (2) the corporation conducts a majority of its business in California. See, e.g., *State Farm*, 114 Cal. App. 4th at 448 (2003); see also Cal. Corp. Code Section 2115 (codified exceptions to the internal affairs doctrine in California Corporations Code section 2116).

Second, California courts have not consistently applied the doctrine. For example, in *Western Air Lines, Inc. v. Sobieski*, 191 Cal. App. 2d 399, 411 (1961), the court applied California law to analyze a Delaware corporation's effort to eliminate cumulative voting for directors. Another court refused to apply the internal affairs doctrine to a case involving alleged insider trading by a corporate director of a Delaware corporation because, in the court's view, California's prohibition on insider trading served "broad public interests." *Friese v. Superior Court,* 134 Cal. App. 4th 693, 710 (2006). Further, specific California statutes may trump foreign law even when they apply to the internal affairs of a foreign corporation. See *Havlicek v. Coast-to-Coast Analytical Servs., Inc.*, 39 Cal. App. 4th 1844 (1995) (applying California law to a director's right to inspect a foreign corporation's records under Cal. Corp. Code Section 1602). Conversely, some courts have applied foreign law to questions that are arguably outside the scope of mere intra-corporate administration. See, e.g., *Patriot Scientific*, 504 F. Supp. 2d at 958-60 (court invalidated alleged oral agreement for stock with employee under Delaware law).

Third, the "lines" courts have drawn between internal and external corporate affairs are vague and potentially malleable. In the recent case of *Lidow v. Superior Court*, 206 Cal. App. 4th 351, 360-64 (2012), the court held that a corporate officer's wrongful termination claim fell outside of the Delaware corporate defendant's internal affairs because it involved California's "vital interests." The Lidow court founded its holding on the plaintiff's allegation that his termination was based on an alleged "violation of [California] public policy," concluding that these allegations "involve circumstances that go beyond internal corporate governance" and involve "vital [state] interests." Other courts have applied the *Lidow* "vital state interests" test to hold other conduct "outside the scope of the internal affairs doctrine." See, e.g., *FDIC v. Van Dellen*, No. CV 10-4915 (C.D. Cal. Oct. 5, 2012) ("vital interests" used to apply California law to FDIC's claims against former officers of Delaware corporation); *FDIC v. Faigan*, No. CV 12-03448 (same).

Fourth, the internal affairs doctrine is often further complicated by contractual choice of law provisions opting for California law. For instance, if an executive of a foreign corporation (Delaware) headquartered in California is sued for breach of fiduciary duty and he has an employment agreement with a California choice of law provision, does California or Delaware law apply to the breach of fiduciary duty claim? Most courts have applied the law of the incorporating state pursuant to the internal affairs doctrine. See, e.g., *Heine v. Streamline Foods, Inc.,* 805 F. Supp. 2d 383 (N.D. Ohio 2011); *Rosenmiller v. Bordes*, 607 A.2d 465, 468-69 (Del. Ch. 1991). However, "[i]n cases in which the parties have made choice-of-law arguments based upon both contractual clauses and the internal affairs doctrine, the Ninth Circuit (applying California law) and the California Supreme Court both have analyzed the choice-of-law clauses before the internal affairs doctrine." *Johnson v. Myers,* No. CV-11-00092 (N.D. Cal. Sept. 30, 2011) (citing *Batchelder v. Nobuhiko Kawamoto,* 147 F.3d 915, 918-20 (9th Cir. 1998); *Nedlloyd Lines B.V. v. Superior Court*, 3 Cal. 4th 459, 464-71 (1992)). The *Johnson* court noted that California law "disfavor[s] the internal affairs doctrine" and has held that a California "choice-of-law clause takes precedence over the internal affairs doctrine."

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The internal affairs doctrine has been inconsistently applied, but it may apply to more than just corporate administrative matters and it could broadly impact certain breach of contract and other employment-related claims. In cases involving foreign corporations or employees, officers, or directors of foreign corporations, attorneys should closely analyze the law of the state of incorporation for potential arguments or defenses that may be apply under the internal affairs doctrine.

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