77.210 4/12/76

Memorandum 76-45

Subject: Study 77.210 - Nonprofit Corporations (Definition of "Pseudo-Foreign" Corporation)

Attached to this Memorandum is a staff draft of proposed Section 7150 (to be included in Chapter 21—Foreign Corporations), which provides the criteria for determining when a foreign nonprofit corporation has become so involved in California affairs (sometimes called a "pseudo-foreign" corporation) that it should be subject to some of the more important regulatory provisions of General Nonprofit Corporation Law. This Memorandum discusses the regulation of foreign corporations under prior General Corporation Law, the changes made in the new law, the concept of the "pseudo-foreign" corporation under Pennsylvania and New York nonprofit corporation law, conflict of laws problems, and the important policy questions entailed in drafting a similar provision in California General Nonprofit Corporation Law.

Regulation of Foreign Corporations Under General Corporation Law

Under prior General Corporation Law, domestic corporations were subject to all of Division 1. See Corp. Code §§ 106, 119. Foreign corporations transacting intrastate business in California were subject to Part 11 of Division 1 (§§ 6200-6804), and a number of other provisions were specifically made applicable to foreign corporations.[1] The remainder of Division 1 did not apply to a foreign corporation, however, even if all the corporation's business and shareholders were in California. See Corp. Code §§ 106, 119; Report of the Assembly Select Committee on the Revision of the Corporations Code 106 (1975)[hereinafter cited as Report].

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1. See Com. Code § 8106 (applicability of Investment Securities Act); Corp. Code §§ 303 (ultra vires defense), 1307, 1309, 1511 (criminal liability for fraudulent acts), 2236 (contest of election of directors), 2413-2415 (immunity of corporation for certain transfers), 2417 (action for new bond after loss or destruction), 3003-3005 (right to inspect corporate records), 3011-3014 (request for special financial statement), 3019-3022 (criminal liability for false report). See generally H. Ballantine & G. Sterling, California Corporation Laws § 388.02, at 721-723 (4th ed. 1975). These provisions have been continued in substance in the new General Corporation Law. See Corp. Code §§ 208, 419-420, 709, 1501, 1600-1603, 2252-2260. The substance of former Part 11 of Division 1 is now found in Chapter 21 of General Corporation Law (§§ 2100-2116).

Under the new General Corporation Law, foreign corporations which conduct most of their activities in California ("pseudo-foreign" corporations) are made subject to a number of important regulatory provisions, including provisions relating to directors (election, removal, filling of certain vacancies, standard of care, liability for unlawful distributions, and indemnification), limitations on corporate distributions, liability of shareholder who received unlawful distribution, annual shareholders' meeting, cumulative voting, reorganizations, dissenters' rights, records and reports, and rights of inspection. See Corp. Code § 2115(b). These provisions apply to foreign corporations transacting intrastate business in California and to "a foreign parent corporation even though it does not itself transact intrastate business" if both of the following tests are met: (1) More than half of its outstanding voting securities are held of record by persons having addresses in California; (2) the average of the corporation's property, payroll, and sales factors (the ratios of the corporation's property, payroll, and sales in California to its total property, payroll and sales) is more than 50 percent during its latest full taxable year. See Corp. Code § 2115; Rev. & Tax. Code §§ 25129, 25132, 25134. For a foreign parent corporation, the latter percentage is computed by aggregating the three factors for the parent and all subsidiaries in which the parent owns more than half of the voting shares, but deducting from the factors of each such subsidiary the percentage of minority ownership thereof. Corp. Code § 2115(b). This information is reported annually by the corporation to the Secretary of State. Corp. Code § 2108(a).

Thus, under the new General Corporation Law, the provisions of Division 1 apply as follows:

1. To domestic corporations, all of Division 1. See Corp. Code § 102.

2. To a foreign corporation transacting intrastate business in California, Chapter 21 (qualification to transact intrastate business, agent for service of process, etc.) and those additional provisions which are specifically made applicable to foreign corporations (see Note 1 supra).

3. To a "pseudo-foreign" corporation transacting intrastate business in California, Chapter 21, the regulatory provisions specified in Section 2115(b), and those additional provisions specifically applicable to foreign corporations (see Note 1 supra).

4. To a "pseudo-foreign" parent corporation which is not itself transacting intrastate business, the regulatory provisions specified in Section 2115(b) and, to some extent, those additional provisions specifically applicable to foreign corporations (see Note 1 supra).

The "Pseudo-Foreign" Corporation Under Pennsylvania and New York Nonprofit Corporation Law

Pennsylvania nonprofit corporation law makes a number of important regulatory provisions applicable to a foreign nonprofit corporation which satisfies either of the following requirements: (1) is "doing business" in Pennsylvania on the basis of the "most minimal contacts" permitted under the U.S. Constitution and "derived more than one-half of its revenues for the preceding three fiscal years" from Pennsylvania, or (2) has "at least a majority" of its "bona fide members" residing in Pennsylvania. See Pa. Stat. Ann. tit. 15, § 8145(a)(1972). New York law contains a similar provision, but casts it in the form of an exemption when the corporation has little contact with New York. See N.Y. Not-for-Profit Corp. Law § 1321 (McKinney 1970). Under the New York scheme, a foreign corporation is exempt from certain regulatory provisions when all of the following tests are met: (1) when its "principal activities" are conducted outside New York, (2) "the greater part of its property" is located outside New York, and (3) if the corporation is a "Type A" corporation (support derived from, and non-pecuniary benefits flow to, members), "less than one-third of its members" are residents of New York; if "Type B" (charitable), "less than ten per cent of its annual revenues is derived from solicitation of funds" in New York; if "Type C" (nonprofit corporation conducting a "business"), "less than one-half of its revenues for the preceding three fiscal years" was derived from New York sources. Id.

Conflict of Laws Problems

The California courts may exercise jurisdiction over a foreign corporation if it has sufficient contacts with California to make it reasonable to require the corporation to defend the California suit. 1

H. Ballantine & G. Sterling, California Corporation Laws § 395.02, at 745.20-745.27 (4th ed. 1975). Traditionally the courts have declined to exercise their contitutional power over foreign corporations when to do so would involve interfering with "internal management and administration" of the corporation. Id. § 388.03, at 723. Under the new General Corporation Law, however, a "pseudo-foreign" corporation is subject to provisions which to some extent regulate its internal affairs "to the exclusion of the law of the jurisdiction in which it is incorporated." See Corp. Code § 2115(b).

The extent to which choice of law rules may be constitutionally compelled has been the subject of extensive commentary. See, e.g., Cheatham, Federal Control of Conflict of Laws, 6 Vand. L. Rev. 581 (1953); A. Ehrenzweig, A Treatise on the Conflict of Laws § 9, at 28-33 (1962). The full faith and credit clause of the United States Constitution and its implementing legislation both literally apply to sister-state laws as well as to judgments. See U.S. Const., Art. IV, § 1; 28 U.S.C. § 1738. The U.S. Supreme Court, however, has applied the full faith and credit clause to sister-state laws only sporadically. See A. Ehrenzweig, supra.

In the context of corporation law, the U.S. Supreme Court held in 1946, by a five to four split decision, that, in a suit for death benefits brought in South Dakota against a fraternal benefit society incorporated in Ohio, the full faith and credit clause required the South Dakota courts to apply the statute of limitations of the state of incorporation (Ohio). See Order of United Commercial Travelers of America v. Wolfe, 331 U.S. 586 (1946). This case has been called "the most serious blow against the local state." Latty, Pseudo-Foreign Corporations, 65 Yale L.J. 137, 164 (1955). The case has been much criticized (id. at 164 n.124), has "not enjoyed much authority" (A. Ehrenzweig, supra § 9, at 30 n.17), and has not been extended beyond fraternal benefit societies (Cheatham, supra at 596). Indeed, the "strength of the fraternal benefit society line of cases may not be very great today." Reese & Kaufman, The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit, 58 Colum. L. Rev. 1118, 1131 n.53 (1958).

None of the full faith and credit cases of the U.S. Supreme Court has involved a pseudo-foreign corporation, and it has been said that it would be "rather shocking" if the principle of the Wolfe case were applied to such a corporation. Latty, supra at 164. In Western Air Lines, Inc. v. Sobieski, 191 Cal. App.2d 399, 12 Cal. Rptr. 719 (1961), the court approved the finding of the Commissioner of Corporations that, although Western Air Lines was incorporated in Delaware, it had sufficiently extensive contacts with California to be properly classed as a pseudo-foreign corporation. The court thus concluded that the California Corporate Securities Law (Corp. Code §§ 25000-25804) could be applied to the corporation so as to preserve the shareholders' cumulative voting rights. The court rejected the contention that the Wolfe case required a finding that the Commissioner of Corporations had exceeded his jurisdiction, noting that the fraternal benefit cases appear to be "unique." 191 Cal. App.2d at 410, 12 Cal. Rptr. at 726.

Thus it appears that California may validly apply its law to a pseudo-foreign corporation to the exclusion of the law of the state of incorporation. See Latty, supra at 164-166; Sobieski, State Blue Sky Jurisdiction Over Foreign Corporations, 14 Hastings L.J. 75, 81-82 (1962). Local corporation law should not be applied "in bulk" to the pseudo-foreign corporation, however, but only those features of local law should be applied which reflect strong public policy protective of local residents. Latty, supra at 172.

Application of the law of the forum state to the exclusion of the law of the state of incorporation raises "the possibility of an impasse when the courts of the local state make a requirement directly opposed to one made by the other state." Latty, supra at 141. This problem may well be minimized, however, by courts of the state of incorporation deferring to the courts of the state where a pseudo-foreign corporation has most of its contacts. For example, while the Western Air Lines litigation was pending in the California courts, the Delaware Chancery Court declined to compel an election of directors under Delaware law. See In re Western Airlines, Inc., 37 Del. Ch. 267, 140 A.2d 777 (1958). And even if the possibility of impasse cannot be eliminated, this does not justify "complete exclusion of local law despite the local character of the enterprise;" the "United States Supreme Court has the role of determining which court, or which law, must give way." Latty, supra at 141.

Policy Questions in Drafting California Statute

1. Which factors should be used to measure the corporation's contact with California?

The various factors used in California business corporation law, and in Pennsylvania and New York nonprofit corporation law, are the following: (1) "revenues" (Penna. and New York); (2) residence of shareholders or members (Calif., Penna., and New York); (3) "principal activities" (New York); (4) "property" (Calif. and New York); (5) "payroll" (Calif.); and (6) "sales" (Calif.). The "property," "payroll," and "sales" factors of California business corporation law would be satisfactory for foreign nonprofit corporations required to file a tax return, but not for the remainder. The staff draft employs the revenue and residence tests of the Pennsylvania statute.

2. Should the tests be alternative or cumulative?

In Pennsylvania, the additional regulation is imposed if the corporation satisfies either the revenue test or the residence-of-members test. Similarly, in New York the additional regulation is imposed if the corporation fails to meet any one of the three criteria for exemption. California General Corporation Law imposes the additional regulation, however, only if both criteria are satisfied (property-payroll-sales, and residence of shareholders). The staff draft follows the General Corporation Law in this respect, and requires that both the revenue and residence tests be met before the additional regulation is imposed.

3. Should proposed Section 7150 include a foreign parent corporation where it does not, but its subsidiary does, conduct intrastate activities in California?

The staff draft of proposed Section 7150 does not contain a provision comparable to the provision of Section 2115 of General Corporation Law which makes the latter section applicable to "a foreign parent corporation even though it does not itself transact intrastate business" if both of the following conditions are met:

(1) The average of the property, payroll, and sales factors for the latest full taxable year is more than 50 percent, computed by aggregating these factors for the parent and all subsidiaries in which the parent owns more than half of the voting shares, but deducting from the factor of each such subsidiary the percentage of minority ownership thereof.

(2) More than one-half of the voting securities of the parent are held of record by persons having addresses in California.

Thus a foreign parent corporation having a majority of its voting securities held by Californians could be brought within the scope of Section 2115 by the involvement of its subsidiary in California commerce, even though the parent had no property, payroll, or sales of its own in California. This may go beyond constitutional limits, since jurisdiction over a subsidiary corporation "does not of itself" confer jurisdiction over the parent, even when the parent owns all of the subsidiary's stock. Watson's Quality Turkey Products, Inc. v. Superior Court, 37 Cal. App.3d 360, 364, 112 Cal. Rptr. 345, 348 (1974); Judicial Council Comment to Code Civ. Proc. § 410.10. Similarly, the mere residence in the state of shareholders will not support jurisdiction over the foreign corporation absent a showing that the corporation is the alter ego of the shareholders. See Sheard v. Superior Court, 40 Cal. App.3d 207, 210, 114 Cal. Rptr. 743, 745 (1974)(question involved was whether jurisdiction over the corporation would support jurisdiction over the shareholders).

The question of whether to regulate a foreign parent nonprofit corporation which controls its subsidiary by holding memberships representing a majority of the voting power appears academic since that situation would seem to occur only rarely. However, under General Corporation Law, the parent may control the subsidiary either "directly or indirectly" (Corp. Code § 175), so long as it has "the power to direct or cause the direction of the management and policies" of the subsidiary (Corp. Code § 160). If "parent" is similarly defined in General Nonprofit Corporation Law, a national organization having a "subordinate body" incorporated in California (see Corp. Code § 9203) could so control the latter that it would come within the statutory definition of a "parent."

If the Commission is of the view that the definition of a "pseudo-foreign" nonprofit corporation should include a foreign parent nonprofit corporation, that could be accomplished by adding the following section:

§ 7151. Application of article to foreign parent nonprofit corporation

7151. A foreign parent nonprofit corporation is subject to this article, whether or not such corporation itself conducts intrastate activities, if all of the following conditions are satisfied:

(a) Jurisdiction may be exercised over such corporation as provided in Section 410.10 of the Code of Civil Procedure.[2]

(b) Either (1) the foreign parent nonprofit corporation derived more than one-half of its revenues during the latest full calendar year, or such portion thereof as the foreign parent nonprofit corporation was in existence, from sources within this state, or (2) the foreign parent nonprofit corporation and all of its subsidiaries derived more than one-half of their combined revenues (excluding transactions between parent and subsidiary or between subsidiaries) during the latest full calendar year, or such portion thereof as at least one of such corporations was in existence, from sources within this state.

(c) More than one-half of the bona fide members of the foreign parent nonprofit corporation are residents of this state.

Respectfully submitted,

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2. Section 410.10 of the Code of Civil Procedure provides: "A court of this state may exercise jurisdiction on any basis not inconsistent with the Constitution of this state or of the United States."

Article 5. Pseudo-Foreign Nonprofit Corporations

§ 7150. Application of article

7150. A foreign nonprofit corporation (other than a foreign nonprofit association) is subject to this article if both of the following conditions are satisfied:

(a) The foreign nonprofit corporation derived more than one-half of its revenues during the latest full calendar year, or such portion thereof as the foreign nonprofit corporation was in existence, from sources within this state.

(b) More than one-half of the bona fide members of the foreign nonprofit corporation are residents of this state.

Comment. Section 7150 establishes the criteria for application of this article to a nonprofit corporation which, though incorporated outside California, "exercises most of its corporate vitality within this state." Western Air Lines, Inc. v. Sobieski, 191 Cal. App.2d 399, 412, 12 Cal. Rptr. 719, 727 (1961). Such corporations are known as "pseudo-foreign" nonprofit corporations. See id. For a comparable provision in General Corporation Law, see Section 2115(a).

Pursuant to Section [2100 of General Corporation Law], the application of this section is limited to foreign nonprofit corporations conducting intrastate activities in California. [If the foreign nonprofit is not conducting intrastate activities in California, it will nonetheless be subject to this article if it is a foreign parent nonprofit corporation which meets the criteria of Section 7151.]

Note. The question of whether the language in parentheses ("other than a foreign nonprofit association") should be retained should be reexamined after the definitional section comparable to Section 171 ("foreign corporation" includes a foreign association unless otherwise stated) has been drafted.