Not So Fast – Challenges in Reincorporating from California to Delaware

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There are several reasons that a California corporation may want to reincorporate to Delaware. Venture capital funds or other investors may demand a reincorporation to Delaware as a condition to financing. Cumulative voting for director elections, required for California corporations but not required for Delaware corporations, may have become a problem. The corporation may want to take advantage of the flexibility of Delaware's business laws, the abundance of legal precedent and the availability of the Court of Chancery to resolve corporate disputes.

Whatever the reason, reincorporating from California to Delaware may be more challenging than originally anticipated due to a few complicating factors: (1) California's long-arm statute, (2) the availability of exemptions from registration and qualification under state and federal securities laws and (3) restrictions under the company's contracts.[1]

California's Long-Arm Statute – CGCL Section 2115

Under California's long-arm statute, Section 2115 of the California General Corporation Law ("CGCL"), a foreign corporation may be considered a "quasi-California" or "pseudo-foreign" corporation depending on the level of the corporation's ties to California and, therefore, purportedly subject to certain provisions of the CGCL, including, without limitation, provisions with respect to the following:

- cumulative voting for director elections;
- fiduciary duties of directors;
- dissenters' rights;
- indemnification of directors, officers and others;
- shareholder approval of mergers and other reorganizations; and
- restrictions on distributions, dividends and share repurchases.

A two-part test is used to determine whether a foreign corporation is subject to CGCL Section 2115:

1. *The Voting Shares Test* – Are more than 50% of the corporation's outstanding voting securities held of record by persons having addresses in California appearing on the books of the corporation?

2. *The Doing Business Test* – Is the average of the corporation's (a) property factor, (b) payroll factor and (c) sales factor more than 50% during the corporation's last full income year?[2] These three factors are defined in Sections 25129, 25132 and 25134 of the California Revenue and Taxation Code, and are calculated by completing Schedule R as part of the corporation's California state tax returns:

    1. *Property Factor* – A corporation's property factor is calculated by dividing (i) the average value of the corporation's real and tangible personal property owned or rented and used in California during the taxable year by (ii) the average value of all of the corporation's real and tangible personal property owned or rented and used during the taxable year.

    2. *Payroll Factor* – A corporation's payroll factor is calculated by dividing (i) total compensation paid in California during the taxable year by (ii) total compensation paid elsewhere during the taxable year.

    3. *Sales Factor* – A corporation's sales factor is calculated by dividing (i) total sales in California during the taxable year by (ii) total sales everywhere during the taxable year.[3]

If both the "voting shares test" and the "doing business test" are satisfied, then the surviving corporation following the reincorporation merger may subsequently become subject to Section 2115 of the CGCL, potentially frustrating the decision to reincorporate in Delaware, particularly if a primary reason is to escape cumulative voting.

Although CGCL Section 2115 seems problematic as written, its bark may be worse than its bite. California-based Delaware corporations have successfully challenged the enforceability of CGCL Section 2115 in court. For example, in *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005), the Delaware Supreme Court rejected CGCL Section 2115 on grounds that it violated the "internal affairs doctrine" under Delaware law, which provides that the law of the state of incorporation should govern any disputes regarding that corporation's internal affairs. Moreover, both California and Delaware courts have enforced forum-selection clauses set forth in the charter documents of Delaware corporations, and are even more likely to do so in the future following Delaware's adoption of Section 115 of the Delaware General Corporation Law ("DGCL") in 2015. DGCL Section 115 explicitly provides that the certificate of incorporation or bylaws of a Delaware corporation may require that any or all internal corporate claims be brought solely and exclusively in Delaware courts.

Exemption from Registration and Qualification under the Securities Laws

Under Rule 145(a)(2), a statutory merger in which the securities of the target corporation will be exchanged for securities of any other person will be deemed to be an offer and sale under the

Securities Act of 1933, as amended (the "Securities Act"), unless the "sole purpose of the transaction is to change an issuer's domicile solely within the United States." What does "sole purpose" mean in this context? It does not mean that there can be no changes to the rights of shareholders in connection with the reincorporation. The SEC Staff has issued many no-action letters that have permitted changes to be made to shareholder rights in connection with a reincorporation merger while still falling within the Rule 145(a)(2) exception.[4] However, it is not entirely clear how many changes can be made before one may question whether the "sole purpose" of the transaction is to change domicile, as opposed to some other purpose, such as eliminating important shareholder rights.

If the parties cannot get comfortable that the "sole purpose" of the transaction is to change the California corporation's domicile, as provided in Rule 145(a)(2), then the reincorporation merger must be analyzed as if it involves the offer and sale of shares by the Delaware corporation to the shareholders of the California corporation. Accordingly, under the Securities Act and applicable "blue sky" laws, the transaction must either be registered or qualified or exempt therefrom. In fact, blue sky laws must also be considered in the Rule 145(a)(2) scenario, because there may not be a similar exception to the definition of offer and sale under state law.

If all of the shareholders of the California corporation are "accredited investors," as defined in Rule 501(a) of Regulation D promulgated under the Securities Act,[5] then the analysis is relatively straight-forward.

Under Rule 506 of Regulation D, a safe harbor for establishing that an offer or sale of securities is a transaction not involving a public offering within the meaning of Section 4(a)(2) under the Securities Act, an issuer may offer and sell securities to an unlimited number of accredited investors and for an unlimited dollar value. Additionally, Rule 506 does not require the issuer to provide any particular information to accredited investors regarding the offering, though the issuer still needs to be mindful of anti-fraud rules, such as Rule 10b-5. Rule 506 has some other requirements, including the requirement to prepare and file with the Securities and Exchange Commission ("SEC") a notice on Form D no later than 15 days after the first sale of securities in the offering, but they are typically "easy bases to tag" for reincorporation transactions.

Securities issued under Rule 506 are "covered securities" under Section 18 of the Securities Act and therefore preempt regulation under state blue sky laws. However, states may require an issuer to file a notice informing the applicable state agency of the Rule 506 offering. For example, CGCL Section 25102.1(d) provides that the issuer must (1) file a copy of the Form D for any Rule 506 offering with the California State Commissioner, (2) file a consent to service of process pursuant to CGCL Section 25165 and (3) pay a filing fee. If the issuer has shareholders in states other than California, then the laws of those states must also be analyzed to see if a notice and/or fee is required.

The analysis gets more complicated if the California corporation has shareholders that do not qualify as "accredited investors." Although an issuer can still rely on Rule 506 if securities will be issued to fewer than 35 unaccredited investors, the compliance burden increases significantly because the issuer will be required to provide to unaccredited investors in advance of the sale of securities (i.e., before the purchase agreement, merger agreement or similar agreement is signed) certain disclosures meeting the line item requirements of Rule 502(b)(2) of Regulation D. This is true irrespective of whether the unaccredited investors have a "purchaser representative" as contemplated by Rule 506(b)(2)(ii).

The required disclosures for unaccredited investors under Rule 506 can be costly and timeconsuming to prepare. These include prescribed financial statement information and non-financial statement information, including the information required by Form S-4 for business combinations. Some relief is given under Rule 502(b) in that such disclosure only needs to be provided “to the extent material to an understanding of the issuer, its business and the securities being offered.”

However, the fact that any disclosure needs to be prepared at all to rely on Rule 506 in an offering to unaccredited investors significantly increases the compliance burden.

In the event that the California corporation has more than 35 unaccredited investors – or if the issuer does not want to prepare the disclosures required by Rule 506 for unaccredited investors – there are alternatives to Rule 506 for an exemption under the Securities Act. For example, if the total value of securities to be issued is less than $5.0 million, then the issuer may be able to rely on Rule 504 of Regulation D for an exemption from registration.[6] Alternatively, the issuer could conclude that the offer and sale of securities is a transaction not involving a public offering under Section 4(a)(2) of the Securities Act applying the Ralston Purina test.[7] Neither Rule 504 nor Section 4(a)(2) requires the issuer to provide any particular disclosure to unaccredited investors, though as noted above an issuer must always be mindful of anti-fraud rules.

The drawback to using Rule 504 or a “naked” Section 4(a)(2) exemption (i.e., relying on Section 4(a)(2) without the Rule 506 safe harbor) is that the offered securities will not be “covered securities” under Section 18 of the Securities Act and therefore will be subject to regulation under state blue sky laws. In California, because the transaction will involve the exchange of securities incident to a merger, the transaction will need to be qualified under CGCL Section 25120 (not CGCL Section 25110), unless there is an available exemption.[8]

The two most promising exemptions from CGCL Section 25120 are typically CGCL Section 25103(c) and CGCL Section 25103(h).

CGCL Section 25103(c) is useful if a number of shareholders have addresses of record outside of California. CGCL Section 23103(c) provides that a transaction incident to a merger is exempt from qualification under CGCL Section 25120 if fewer than 25% of shareholders of each class of stock have addresses in California. However, for purposes of this calculation, under CGCL Section 25103(d), any securities held to the knowledge of the issuer in the names of broker-dealers or nominees of broker-dealers or any securities controlled by any one person who controls directly or indirectly 50% or more of the outstanding securities of that class shall not be considered outstanding. It is important to note that the exemption is based on shareholders with “addresses” in California, not “residences” in California, so there is a little room to maneuver there.

CGCL Section 25103(h) provides an exemption from qualification under CGCL Section 25120 if the following criteria are satisfied:

- The transaction, had the exchange transaction involved the issuance of a security in a transaction subject to the provisions of Section 25110, would be exempt from qualification under Section 25102(f); and

- Either:

    - Not less than 75% of shares voted for the transaction, not less than 10% of shares voted against the transaction and shareholders have dissenters’ rights with respect to the transaction; or

    - The transaction is “solely for the purposes of changing the issuer’s state of incorporation or organization” or form of organization, all securities of a similar class are treated equally, and the holders of nonredeemable voting equity securities receive nonredeemable voting equity securities.

Turning to the first prong of the test under CGCL Section 25103(h), the following criteria would need to be satisfied for a transaction to be exempt under CGCL Section 25012(f):

- Sales of the security must not be made to more than 35 unaccredited investors, including persons not in California (no limit on accredited investors);
- Each of the participants in the exchange must have a preexisting business relationship with the offeror or any of its partners, officers, directors or controlling persons, or by reason of his or her business or financial experience could be reasonably assumed to have the capacity to protect his or her own interests in connection with the transaction;
- Each of the participants in the exchange must be purchasing for his or her own account and not with a view to or for the sale in connection with any distribution of the security; and
- The offer and sale of the security must not be accomplished by the publication of any advertisement.

Other potential bars for the applicability of CGCL Section 25103(h) would be if dissenters’ rights do not apply to the transaction. In that case, the Delaware corporation would not qualify for an exemption based on the requirement under CGCL Section 25103(h)(1)(A) that the proposed transaction provide for dissenters’ rights. We note that a potential work-around here could be to contractually provide for dissenters’ rights in connection with the reincorporation transaction.

In addition, whether a reorganization merger would be “solely for the purposes” of changing the state of incorporation, as required under CGCL Section 25103(h)(1)(B), could be challenged to the extent there are differences in shareholders’ rights under the surviving corporation when compared to the disappearing corporation, such as the removal of cumulative voting of directors.

California law lacks helpful precedent on the issue of whether a reorganization merger would be “solely for the purposes” of changing the state of incorporation. As persuasive authority, the SEC has issued some no-action letters that address the issue of whether the “sole purpose” of a transaction is “to change an issuer’s domicile solely within the United States,” in the context of interpreting Rule 145(a)(2). In such letters, the Staff granted no-action relief in certain situations where a change in the state of domicile was accompanied by revisions to the issuer’s charter and bylaws that included provisions that could not have been adopted under the laws of the company’s prior state of incorporation. It is unclear, however, whether California would grant similar relief.

Fairness Hearing

If Rule 506 does not work and you do not qualify for an exemption from qualification under the CGCL, you would need to apply for a permit to qualify the issuance of shares with the California Department of Business Oversight (“DBO”). You would do so through the process of a fairness hearing, which is provided for under CGCL Section 25142.

During the fairness hearing, the DBO will examine all relevant factors in determining whether the transaction is fair and equitable, with the following factors considered to be the most material:

- the primary reasons for the reincorporation;
- whether there are any significant objections to the reincorporation;
- how shareholders are treated in connection with the reincorporation;
- whether adequate notice of the reincorporation was provided to shareholders; and
- whether the reincorporation was approved by shareholders.

If the DBO determines that the transaction is fair, the Commissioner will issue a permit allowing the Delaware corporation to issue shares to the California corporation's shareholders in connection with the reincorporation merger. As an added bonus, the transaction would then qualify for an exemption under Section 3(a)(10) of the Securities Act based on the DBO approving the issuance of shares through the fairness hearing process, so the reincorporation would also be covered on the federal side.

<u>Other State Exemptions</u>

As noted above (in the context of offerings to accredited investors), if some shareholders are located in states other than California, you would need to look at securities regulations in those states to determine whether the merger transaction would qualify for a securities exemption or would need to be registered and qualified in those states.

Contractual Approvals

Aside from procedural and securities law requirements of reincorporating a California corporation in Delaware, you need to consider the effect of the merger on the corporation's contracts.

As part of the merger transaction, the California corporation would be assigning its assets and liabilities by operation of law to the newly-formed Delaware corporation, including its existing contracts with customers, suppliers, landlords, lenders and other counterparties. To the extent that any of your agreements contain language restricting assignment – by operation of law or otherwise – reincorporating would constitute a technical breach of these agreements. As a result, before deciding to reincorporate, it is advisable to review your material contracts to confirm whether the merger transaction would require notice or consent, constitute an event of default, or otherwise constitute a breach. If so, it may be worth requesting counterparty consent for any material contracts prior to reincorporating.

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[1] The basic process for reincorporating your California corporation in Delaware is relatively straightforward. The first step is organizing a new corporation in the State of Delaware by submitting a Certificate of Incorporation with the Delaware Secretary of State. In conjunction with filing the Certificate of Incorporation, the Delaware corporation would adopt bylaws to establish the governing rules of the corporation in the reincorporation merger. Next, the California and the Delaware corporations would merge, with the California corporation as the disappearing corporation and the

Delaware corporation as the surviving corporation.

To complete the merger, you would be required to comply with the requirements under both California and Delaware corporate law. Under California law, both board and shareholder approval must be obtained. Although CGCL Section 1201(b) provides that shareholder approval is not required if the shareholders of the disappearing corporation possess more than five-sixths of the voting power of the surviving corporation, CGCL Section 1201(d) states that the principal terms of the merger must be approved by shareholders if the shareholders receive shares of the surviving corporation having different rights, preferences, privileges or restrictions than the shares surrendered. CGCL Section 1201(d) also states that shares in a foreign corporation received in exchange for shares in a domestic corporation are necessarily considered to have different rights, preferences, privileges or restrictions.

After board and shareholder approval of the merger is obtained, the California corporation would file a Certificate of Ownership with the California Secretary of State. The filing would be accompanied by a resolution or plan of merger adopted by the board of the California corporation, authorizing the merger and setting forth its terms. As a final step, upon receipt of the Certificate of Ownership and Merger from the Delaware Secretary of State, the

California corporation would submit a certified copy of the Certificate of Ownership and Merger to the California Secretary of State to complete the merger filings in California.

In Delaware, only board approval and Secretary of State filings are required. To complete the merger in Delaware, the Delaware corporation would file a

Certificate of Ownership with the Delaware Secretary of State as well as the merger authorizing resolutions adopted by its board. Shareholder approval would not be required because, under DGCL Section 253(a), the California corporation would own more than 90% of the outstanding shares of the Delaware corporation upon its formation.

[2] Because the “doing business test” calculations are dependent on the availability of year-end financial information, the requirements of CGCL Section 2115(b) become applicable only upon the first day of the first income year of the corporation commencing on or after the 135th day of the income year immediately following the latest income year with respect to which the “voting shares test” and the “doing business test” have been met, per Section 2115(d) of the CGCL.

[3] Schedule R and its accompanying instructions can be located on the California Franchise Tax Board’s website (Schedule R for 2017; instructions for Schedule R for 2017).

[4] For example, Russell Corp. (March 18, 2004) (https://www.sec.gov/divisions/corpfin/cf-noaction/russellcorp031804.pdf).

[5] “Accredited investor” is defined in Rule 501(a) of Regulation D, and includes the following main categories:

1. Directors, executive officers, and general partners of the issuer.
2. Any natural person whose net worth either individually or jointly with their spouse equals or exceeds $1 million.
3. Natural person investors who have income in excess of $200,000 in each of the two most recent years and who reasonably expect an income in excess of $200,000 in current year (or $300,000, jointly with their spouse).
4. Any trust not organized for the specific purpose of acquiring the securities offered, in which case each beneficial owner of the security is counted separately.

[6] As with an offering exempt from registration under Rule 506 of Regulation D, Form D must be filed in connection with an offering that relies on Rule 504 of Regulation D for an exemption from registration.

[7] Under the Ralston Purina test, an offering is exempt from registration if it would be considered a “private offering” as opposed to a “public offering,” with a balancing of four factors: (a) the number of offerees and their relationship to each other and the issuer, (b) the number of securities offered, (3) the size of the offering and (4) the manner of the offering. The relationship of the offerees to the issuer is significant, where an offering to members of a class who should have special knowledge based on their relationship to the issuer being less likely to be a public offering than an offering to members of a class who do not have that advantage.

[8] Transactions subject to CGCL Section 25120 are not also subject to CGCL Section 25110. Per Section 4.5 of the *Guide to California Securities Law Practice*, Corporations Committee of the Business Law Section of the State of California, “by its express terms, [CGCL Section] 25110 applies only to those issuer transactions that are not subject to [CGCL Section] 25120. If an issuer transaction is subject to [CGCL Section] 25120 *et seq.*, then [CGCL Section] 25120 and the regulations related thereto, and not [CGCL Section] 25110, apply to the transaction.”

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