PREINCORPORATION PLANNING

A. WHERE TO INCORPORATE

[3:1] Whenever the decision has been made to incorporate, a threshold consideration is *where* to incorporate: i.e., under which state's laws should the corporation be formed?

Corporate laws differ from state to state, in varying degrees. But, if the corporation is going to have significant business or shareholder "contacts" or "presence" in California, there is usually no reason to incorporate outside the State.

For the reasons discussed below (¶*3:2 ff.*), a California corporation is ordinarily the logical choice for a business that is "centered" here.

1. [3:2] **Filing Fees and Annual Reports:** An out-of-state corporation must "qualify" to do business in California (Corps.C. §2105), which requires payment of filing fees to the Secretary of State in addition to whatever filing fees were paid in its state of incorporation. This duplication of filing fees can be avoided by forming a California corporation. Further, a foreign corporation qualified to do business in California must annually file with the Secretary of State an information statement (Corps.C. §2117) comparable to the statement California corporations are required to file (*see* ¶*4:474 ff.*).

2. [3:3] **State Taxes:** An out-of-state corporation, doing business in California, will have to pay a franchise tax to the State of California (Rev. & Tax.C. §23151). It may *also* have to pay a franchise tax in the state of its incorporation, even if not doing business there. Thus, incorporating elsewhere when planning to do business in California potentially exposes the corporation to taxation by two states.

3. [3:3.1] **Securities Laws:** The requirements of the California Corporate Securities Law apply to any offer or sale of a security "in this state," regardless of the issuer's state of incorporation (*see* ¶*5:195 ff.*).

4. [3:4] **Corporate Laws:** No matter where the corporation is incorporated, various provisions of the California General Corporation Law may nonetheless apply to the corporation. And a foreign corporation located or doing substantial business in California may find itself caught in conflicts between the corporate laws of California and its state of incorporation.

    a. [3:4.1] **"Internal affairs" doctrine:** The internal affairs doctrine is a *conflict of laws* principle holding that only the corporation's *state of incorporation* should regulate the corporation's "*internal affairs*"—i.e., matters relating to the

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corporation's *organic structure* or *internal administration*. Stated otherwise, a corporation's "internal affairs" involve "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders." [*Edgar v. MITE Corp.* (1982) 457 US 624, 645, 102 S.Ct. 2629, 2642; *Drulias v. 1st Century Bancshares, Inc.* (2018) 30 CA5th 696, 705, 241 CR3d 843, 851; *Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 358-359, 141 CR3d 729, 733-734; Rest.2d Conflict of Laws §302, Comment "e"; see *Greb v. Diamond Int'l Corp.* (2013) 56 C4th 243, 264-269, 153 CR3d 198, 214-219 & fn. 35]

(1) [3:4.2] **Examples:** "Internal affairs" traditionally governed by the corporate laws of the state of incorporation include:

- Steps taken in the course of the original incorporation;
- Election or appointment of directors and officers;
- Adoption of bylaws;
- Corporate aspects of share issuance and reclassification;
- Preemptive rights;
- Directors' and shareholders' meetings;
- Shareholders' rights to examine corporate records;
- Amendment of articles and bylaws;
- Shareholder standing to bring or maintain a derivative action (*Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 934, 162 CR3d 300, 308; *Villari v. Mozilo* (2012) 208 CA4th 1470, 1479, 146 CR3d 556, 562, fn. 9, ¶*6:618*); and
- Procedures for mergers, consolidations and other reorganizations. [See *Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 359, 141 CR3d 729, 734; *State Farm Mut. Automobile Ins. Co. v. Sup.Ct. (Hill)* (2003) 114 CA4th 434, 442-447, 8 CR3d 56, 63-67—directors' decision not to pay dividends was "internal affairs" matter governed by law of state of incorporation; Rest.2d Conflict of Laws §302, Comment "a"]

Caution: Statutory and case law have applied *California* law, rather than the law of a foreign corporation's state of incorporation, to some matters found on the above list; *see* ¶*3:6, 6:137*.

(2) [3:4.3] **Directors' duties:** California has partially codified the "internal affairs" doctrine. Directors of a foreign corporation doing business in California are liable for unauthorized dividends, share purchases or asset

distributions, as well as for false certificates, reports, public notices "or other violation of official duty," according to the laws of the *state of incorporation*. [Corps.C. §2116; see *Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 934, 162 CR3d 300, 308—§2116 provides that law of state of incorporation "governs the liability of directors to the corporation and its shareholders"; *Villari v. Mozilo* (2012) 208 CA4th 1470, 1479, 146 CR3d 556, 562, fn. 9; also see *Drulias v. 1st Century Bancshares, Inc.* (2018) 30 CA5th 696, 706, 241 CR3d 843, 851-852, *discussed at ¶4:397.12 ff.*]

(a) [3:4.4] **Limitation—insider trading:** California's statutory prohibition on insider trading (Corps.C. §25402) applies to directors of foreign corporations present in California; *see ¶6:388.5*.

(b) [3:4.5] **Limitation—directors of "pseudo-foreign corporations":** California corporate law governing the directors' *standard of care* (Corps.C. §309) applies to directors of "pseudo-foreign corporations." [Corps.C. §2115(b); *see ¶3:6*]

(3) [3:4.6] **Limitation—local state having "more significant relationship":** Although a matter may touch upon the corporation's "internal affairs," the law of the state of incorporation is *not* applied where another state has a "more significant relationship" to the parties and transaction at issue. [*Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 359, 141 CR3d 729, 734 (*discussed further at ¶6:267.6*); *Vaughn v. LJ Int'l, Inc.* (2009) 174 CA4th 213, 225-226, 94 CR3d 166, 175-176; Rest.2d Conflict of Laws §§302, 309]

Indeed, the "more significant relationship" exception can be said to form the basis of the Corps.C. §2115 "pseudo-foreign corporation," *¶3:5 ff.*

(4) [3:4.7] **Compare—"procedural" matters:** The internal affairs doctrine does not extend to matters properly governed by local forum rules, such as determining whether an action is properly characterized as legal (triable by jury) or equitable (triable by the court). [*Central Laborers' Pension Fund v. McAfee, Inc.* (2017) 17 CA5th 292, 344-350, 225 CR3d 249, 294-300—suit brought in California alleging breach of fiduciary duty by Delaware corporation directors was governed by California law which determined action was equitable in nature and hence triable by court; *see ¶6:252.3*]

b. [3:5] **"Pseudo-foreign corporations":** Many (but not all) provisions of the California General Corporation Law expressly apply if the corporation has sufficient "presence" here. An out-

of-state "unlisted" corporation (*see* ¶*3:7.1*) is treated as a "*pseudo-foreign corporation*," and thus subject to specified provisions of California law, if:

- More than half its business (based upon a three-factor formula including property, payroll and sales) is done in California (the "doing-business" test); *and*
- More than half of its voting securities are held of record by persons having addresses within the state (the "voting-stock" test). [Corps.C. §2115(a); see *Kruss v. Booth* (2010) 185 CA4th 699, 715-723, 111 CR3d 56, 70-77; see also *State Farm Mut. Automobile Ins. Co. v. Sup.Ct. (Hill)* (2003) 114 CA4th 434, 448, 8 CR3d 56, 69]

(1) [3:6] **California law governs:** Such a "pseudo-foreign corporation" is subject to certain *enumerated* (but by no means all) provisions of the Corporations Code to the *exclusion* of the law of the state of incorporation. Many of these provisions relate to the corporation's "internal affairs" (*see* ¶*3:4.1 ff.*) and would not otherwise apply to foreign corporations. These provisions include such major shareholder protections as the shareholders' right to elect directors annually by cumulative voting (Corps.C. §708; *see* ¶*6:137*), directors' duties of care to the corporation (Corps.C. §309), limitations on indemnification of directors (Corps.C. §317), and limitations on corporate distributions (Corps.C. §§500-505). [See Corps.C. §2115(b); *Greb v. Diamond Int'l Corp.* (2013) 56 C4th 243, 251-252, 153 CR3d 198, 203-204]

(2) [3:6.1] **When "pseudo-foreign" corporation becomes subject to California law:** A "pseudo-foreign corporation" that meets both the Corps.C. §2115(a) "doing-business" and the "voting-stock" tests (¶*3:5*) does not immediately become subject to the enumerated provisions of California law. Rather, a time lag is imposed by statute. The corporation becomes subject to the enumerated provisions on the first day of the corporation's first income year commencing on or after:

- The 135th day of the income year immediately following the latest income year with respect to which the §2115(a) tests have been met; *or*
- Entry of a final court order declaring that the §2115(a) tests have been met. [Corps.C. §2115(d); see *Kruss v. Booth* (2010) 185 CA4th 699, 719-723, 111 CR3d 56, 74-77 (noting time lag can be approximately 3 years)]

(a) [3:6.2] **When "pseudo-foreign" corporation no longer subject to California law:** A similar time lag is imposed when a "pseudo-foreign corporation" ceases to meet the Corps.C. §2115(a) tests. The corporation ceases to be subject to the enumerated provisions of California law at the end of:

- The first income year immediately following the latest income year with respect to which at least one of the §2115(a) tests is not met; *or*
- The income year during which a final court order has been entered declaring that one of the §2115(a) tests is not met (provided that no contrary order is entered before the income year ends). [Corps.C. §2115(e); see *Kruss v. Booth* (2010) 185 CA4th 699, 722-723, 111 CR3d 56, 76-77]

(3) [3:7] **Constitutionality?** California courts have upheld the constitutionality of the "pseudo-foreign corporation" statute against equal protection, due process, and full faith and credit challenges. [See *Wilson v. Louisiana-Pacific Resources, Inc.* (1982) 138 CA3d 216, 222-224, 228-231, 187 CR 852, 856-858, 860-863 (imposing California cumulative voting requirements on Utah corporation); *Valtz v. Penta Investment Corp.* (1983) 139 CA3d 803, 806-810, 188 CR 922, 924-926 (applying California shareholders' inspection rights to Delaware corporation); see also *Greb v. Diamond Int'l Corp.* (2013) 56 C4th 243, 251-252, 153 CR3d 198, 203-204 & fn. 10]

But the Delaware Supreme Court has held that Corps.C. §2115 runs afoul of the Commerce Clause, which prohibits multiple states from regulating subjects, such as the internal affairs of a corporation, that require *one uniform system of regulation*. The Court also ruled §2115 violates the principle that a corporation's *internal affairs* should be governed *exclusively* by the law of the state of *incorporation*. [*VantagePoint Venture Partners 1996 v. Examen, Inc.* (Del. 2005) 871 A2d 1108, 1115-1118 (applying Delaware law treating all classes of stock as one class for purposes of voting on merger and rejecting application of §2115 that would require approval by each class of stock and thereby allow one class to block merger); see *Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.* (Del. 2011) 34 A3d 1074, 1082]

(a) [3:7a] **Comment:** In view of the Delaware Supreme Court's refusal to apply Corps.C. §2115, California investors in a foreign corporation having significant contacts in California should be cautious about relying on the statute's protections.

(4) **Exceptions**

(a) [3:7.1] **"Listed" companies:** Corps.C. §2115 does *not* apply to foreign corporations having outstanding securities listed on the New York Stock Exchange, NYSE American (previously NYSE Amex), Nasdaq Global Market or Nasdaq Capital Market. [Corps.C. §2115(c)]

(b) [3:7.2] **Wholly-owned subsidiaries of exempt foreign corporations:** Likewise exempted from treatment as a "pseudo-foreign corporation" are corporations whose voting shares are all owned (directly or indirectly) by a corporate parent *not* subject to Corporations Code §2115. [Corps.C. §2115(c)(2)]

[3:7.3-7.4] *Reserved.*

(5) [3:7.5] **Duty to advise of pseudo-foreign corporation status:** A pseudo-foreign corporation must respond within 30 days of receiving a written request from any shareholder of record, officer, director, employee, agent or creditor inquiring whether the corporation is a pseudo-foreign corporation. Failure to truthfully respond risks penalties of $25 per day (maximum $1,500) from the date the request was received plus, in the court's discretion, court costs and reasonable attorney fees. [Corps.C. §§2115(f), 2200]

B. PLANNING FINANCIAL-CONTROL STRUCTURE

[3:8] Following a decision to incorporate, in California or elsewhere, the first step is to plan the financial and control structure of the proposed corporation.

Such planning normally involves the following steps:

- First, it must be determined what each of the participants is contributing *to* the enterprise (and its *value*, if other than cash; *see* ¶*3:307*).
- Second, what the parties each expect to derive *from* the enterprise must be considered in the way of salaries, dividends, etc.; as well as their expectations re management and control (*see* ¶*3:144*).
- Next, the various alternatives that might accommodate these objectives must be considered, together with the tax ramifications of each such alternative.
- Finally, a plan must be designed that allocates financial interests and control in accordance with the clients' objectives, *at the least possible cost tax-wise*.

[3:9-12] *Reserved.*

[3:13] ***PRACTICE POINTER:*** Planning takes time and requires careful consultation with the client. Since each deal differs somewhat, beware of recommending some "standard" or "usual" arrangement, or relying too heavily on agreements used in some previous deal. Such arrangements may prove unworkable for the clients, necessitating later revisions. Once shares are issued, amendments are costly and expensive, and may also be subject to qualification requirements under the Corporate Securities Law (as "recapitalizations"; *see* ¶*8:119*).

1. [3:14] **Allocating Financial Interests—"Debt" vs. "Equity":** In allocating financial interests in the corporation, the basic choice is between *equity* investment (stock ownership) and *debt* investment (loans to the corporation). Often, the plan for initial capitalization will include *both* "equity" and "debt" investment.

   a. [3:15] **Basic distinction between "equity" and "debt":** "Equity" participation involves an *ownership* interest in the corporation. Normally, it is reflected by issuance of shares of stock, either common or preferred, with such rights as provided in the articles of incorporation (*see* ¶*4:28*). Control of the corporation normally belongs to those holding a majority of its voting stock (although other devices for allocating control may exist, *see* ¶*3:144 ff.*).

      On the other hand, "debt" participation involves a loan of money or other property to the corporation. Unlike equity investments, "debt" must be repaid, with interest, at some fixed maturity. Holders of debt instruments are *creditors* of the corporation. As such, they are entitled to priority over the shareholders in claims against the corporate assets; but are *not* ordinarily entitled to any voice in management and control.

      [3:16] *Reserved.*

      (1) [3:17] **Hybrid arrangements:** Sometimes, the distinction between "equity" and "debt" becomes blurred. For example, debt instruments (notes, bonds, debentures) may be issued with *conversion* rights that entitle the holder to exchange them for an equity position (common or preferred stock); *see* ¶*3:119*. And "loans" may be made to the corporation on such favorable terms (e.g., modest interest, extended maturity) that they may be treated as an "equity" investment for tax and corporate law purposes; *see* ¶*3:28, 3:41*. [See generally, *Hewlett-Packard Co. v. Commr.* (9th Cir. 2017) 875 F3d 494, 495-496]

   b. [3:18] **Choice depends on clients' objectives:** It is up to the clients to decide whether, and how much of, their investment in the corporation shall be in the form of "equity" (shares) or "debt" (loans). Their decision will usually reflect a *balancing* of various separate objectives:

      (1) [3:19] **Corporate control objective:** Corporate control ordinarily rests with the shareholders, not the creditors

of the corporation. The shareholders have the right to elect the board of directors, and thus ultimately control management of the corporate business.

(2) [3:20] **Financial objectives:** "Equity" investors look primarily for increased value of their investment. Shareholders may have dividend rights, but dividend payment is usually dependent on earnings and profits; and even then, rests within the sound discretion of the board of directors. Thus, shareholders have no guarantee of *any* return on the investment or right to repayment. Their main objective is the *potential for profit* when the shares are sold or the corporation liquidated.

On the other hand, there is no potential for enhanced value with a straight "debt" investment. Rather, the lender settles for a fixed right to repayment of the lender's investment at some future time, and to receipt of interest in the interim, all in accordance with the terms of the debt instrument. Payment will be due regardless of the availability of earnings and profits, and will not be dependent on action by the board of directors.

[3:21] *Reserved.*

(3) [3:22] **Flexibility:** Share issuance offers only limited flexibility, since all shares of the same class or series must have the same rights and restrictions. Although the board of directors retains considerable discretion as to the *consideration* for which shares may be issued (*see* ¶*3:318*), once the shares are issued, control generally rests with the shareholders holding a majority of the voting shares. It is difficult, therefore, to cut different deals for different investors without creating multiple classes of stock (e.g., voting and nonvoting common, or one or more classes of preferred stock).

On the other hand, there is tremendous flexibility with debt investments. If necessary, each debt-holder (creditor) can be given a different deal: i.e., different interest rate, maturity date, conversion rights, etc. Certain debtholders can be made more secure by providing collateral to secure their loans; others can be made less secure by providing that their loans can be subordinated to other financing.

[3:23] *Reserved.*

(4) [3:24] **Consideration to be paid by investor:** Another advantage of debt investment is that it can be issued for any lawful consideration—including some forms that might *not* be allowed for stock issuance: e.g., promises to perform *future* services, or covenants not to compete, or proprietary "knowhow" (*see* ¶*3:308*).

(5) [3:25] **Tax objectives:** The clients will normally seek the most favorable tax treatment for the corporation and themselves individually. *See* ¶*3:33 ff.*

c. [3:26] **Counsel's responsibility re choice:** Although the choice between equity and debt rests ultimately with the clients, it is counsel's responsibility to make sure they understand the tax and nontax ramifications of their decision. Typically, clients will expect counsel to *recommend* a financial structure that best accomplishes the various objectives above (¶*3:18 ff.*).



[3:27] ***PRACTICE POINTER:*** Because of the many possible alternatives and their differing consequences, this may be your most important responsibility in organizing a corporation. The complexity of the plan usually depends on the similarity of the client's objectives. The more diverse their interests, the more complex the financial and control structure will become.

Usually, the plan you suggest should *balance* the various objectives above (¶*3:18 ff.*). It should accommodate whatever control structures are desired by the parties, while at the same time protect their respective financial interests—at the least possible cost tax-wise.

d. **Nontax factors affecting choice**

(1) [3:28] **Requirement that corporation issue some capital stock:** To complete its formation as a separate entity, the corporation must issue *some* capital stock—i.e., if its only capital consists of loans, the corporate structure is incomplete, as there are no shareholders to exercise voting rights, etc. In such event, the advantages sought by incorporation (e.g., tax benefits, avoidance of personal liability, etc.) would be jeopardized.

(2) [3:29] **Requirement that capitalization be "adequate" for expected liabilities:** Further, to avoid exposing shareholders to alter ego liability, the corporation must be capitalized (through a combination of equity and loans) in an amount that is "adequate" to give it *independent substance* in relation to third party obligations likely to be incurred in connection with the corporation's business. If the amount of stock issued is "trifling compared with the business to be done and the risks of loss," the corporate veil may be "pierced" and those operating the corporation held personally liable for its debts. [*Minton v. Cavaney* (1961) 56 C2d 576, 580, 15 CR 641, 643—attorney who formed corporation and served as officer and director held personally liable for its torts where corporation never issued shares; *see* ¶*2:53*]

[3:29.1] ***PRACTICE POINTER:*** Although there is no "bright-line" test re what constitutes "adequate" capital, the initial shareholders should, at a minimum, capitalize the corporation with sufficient funds and other assets necessary to enable the business to reach its projected break-even (based on their own *reasonable and good faith estimates* as to when projected business income will cover estimated expenses).

If they do so, the initial shareholders should be able to avoid alter ego liability based on under-capitalization even if their projections turn out wrong and the business fails (as so many do).

(3) [3:30] **Subordination of shareholder-held debt if corporation insolvent:** If the capitalization is "too thin" (i.e., mostly loans from shareholders, very little capital stock), the shareholder-held debt may be *subordinated* to the claims of third-party creditors of the corporation. The effect is to give the outside creditors "first crack" at the corporation's assets.

This may be true even if the shareholders' creditor claims are secured and the other creditors' claims are unsecured. [See *Taylor v. Standard Gas & Elec. Co.* (1939) 306 US 307, 322-323, 59 S.Ct. 543, 550; and *Pepper v. Litton* (1939) 308 US 295, 312, 60 S.Ct. 238, 248]

Subordination is an equitable remedy, and therefore usually requires a showing of bad faith in the under-capitalization, or *breach of fiduciary duty* to the creditors involved.

(a) [3:31] **Example:** X loaned personal funds to his wholly-owned corporation. It had very little capital and soon was insolvent. X then used its remaining funds to repay the corporation's debt to him, leaving it totally without assets for the other creditors. X was held to owe a *fiduciary duty* to the other creditors not to take personal advantage of the corporate assets, and therefore liable to them for the funds obtained. [*Commons v. Schine* (1973) 35 CA3d 141, 145, 110 CR 606, 609]

(4) [3:32] **Comment:** There is no set formula as to the amount of capital stock that must be issued to avoid the risks enumerated above (¶*3:28 ff.*). It should be noted, however, that a debt vs. equity ratio that would suffice for *tax* purposes (*see* ¶*3:50*) *may or may not* suffice to prevent "piercing" the corporate veil and subordination of shareholder-held debt on insolvency. These are equitable doctrines and are discretionary with the court; they depend largely on the *degree* of injustice or bad faith involved in the particular case.