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STATE TAKEOVER LEGISLATION AND THE COMMERCE CLAUSE: THE "FOREIGN" CORPORATIONS PROBLEM

JED RUBENFELD*

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I. INTRODUCTION

That a corporation should be "incorporated" in, or "chartered" by, a particular state is a peculiar and vexing circumstance. It is by no means immutable. A federal corporations code has been mooted about, multi-state-chartered corporations occasionally appear, and murmurs of doing away with the entire concept of "chartering" a corporation have been heard from time to time. But state incorporation is the ruling corporate form, and the problem it creates is a serious and thorny one: the problem, that is, of regulating "foreign" corporations. How far may one state go in regulating another state's corporations?

Traditionally, the answer to this question has been that a state may not regulate a foreign corporation's "internal" affairs.¹ The incorporating state alone, it is said, may govern matters affecting the corporation, its

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¹ See, e.g., *First Nat'l City Bank v. Banco para el Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983); *Shaffer v. Heitner*, 433 U.S. 186, 215 n.44 (1977); *Davis & Cox v. Summa Corp.*, 751 F.2d 1507, 1527 (9th Cir. 1985).

stockholders and directors *inter se*.² Without this "internal affairs doctrine," some have warned, corporate governance could be plunged into a paralyzing choice-of-law confusion.³ Even the Second Restatement of Conflicts of Law clings tenaciously to the internal affairs doctrine⁴ while advocating a much looser "interest analysis" for most other conflicts situations. Yet for all its advocacy, the Restatement never contends, or even suggests, that the internal affairs doctrine is constitutionally mandated.

The Supreme Court, however, confronted in two cases with state regulation of corporate takeovers, may now be saying just that. First, in *Edgar v. MITE Corp.*,⁵ the Court held that an Illinois takeover statute purporting to regulate both domestic and foreign corporations violated the Commerce Clause. Justice White's majority opinion included language so broad as to intimate that any state regulation of the internal affairs of a foreign corporation might be unconstitutional.⁶

Then, in 1987, in *CTS v. Dynamics Corp. of Am.*,⁷ the Court upheld an Indiana takeover law directed only at domestically chartered corporations. The Indiana statute, called a "control shares" statute, prevented acquirors from obtaining control of a corporation unless a majority of the shareholders consented to the acquisition in advance.⁸ In upholding this law against a Commerce Clause challenge, the Court once again suggested that a law regulating the internal affairs of foreign corporations might not pass constitutional muster:

This Court's recent Commerce Clause cases also have invalidated statutes that adversely may affect interstate commerce by subjecting activities to inconsistent regulations. . . . The Indiana Act poses no such problem. *So long as each State regulates voting rights only in the corporations it has created, each corporation will*

² See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 comment a (1971) [hereinafter RESTATEMENT].

³ See, e.g., *Robert A. Wachslar, Inc. v. Florafax Int'l, Inc.*, 778 F.2d 547, 550 (10th Cir. 1985); Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 48-50 (1985); Reese & Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 1118, 1126-27 (1958).

⁴ See RESTATEMENT, *supra* note 2, at §§ 302-10.

⁵ 457 U.S. 624 (1982).

⁶ See *id.* at 645-46 ("Illinois has no interest in regulating the internal affairs of foreign corporations.").

⁷ 107 S. Ct. 1637 (1987).

⁸ IND. CODE § 23-1-42-1 (Supp. 1986). The Indiana Act works as follows: If a person acquires stock, bringing his holding over certain designated thresholds (20%, 33-1/3%, or 50%), his stock purchase does not carry voting power with it unless a majority of disinterested shareholders—at a general or special meeting—vote to confer such voting power upon him. About a dozen states currently have control shares statutes, most of which are substantially similar to the Indiana act.

be subject to the law of only one State. . . . Accordingly, we conclude that the Indiana Act does not create an impermissible risk of inconsistent regulation by different States.⁹

In two cases, *McDermott v. Lewis*¹⁰ and *TLX Acquisition Corp. v. Telex Corp.*,¹¹ courts have already drawn from this language the inference suggested above: that a state cannot regulate the internal affairs of a foreign corporation (at least with respect to shareholder voting rights) without violating the Commerce Clause.¹²

This inference is without doubt an appealing one. It provides a clean, clear constitutional rule at a time when the Constitution has been otherwise providing nothing but unwieldy standards. It makes a certain intuitive sense. And it even seems to be a logical deduction from the Court's holding in *CTS*.

Unfortunately, the inference is also untenable. The holding in *Telex* and *McDermott* is not logically required by anything the Court said in *CTS*.¹³ There has never been and could not be a rule under the Commerce Clause that all state laws subjecting interstate commerce to a risk of inconsistent regulations are unconstitutional.¹⁴ The Court cannot have meant in *CTS* to constitutionalize the internal affairs doctrine; or, if the Court was leaning in that direction, it owes us a much better account of this conclusion than has yet been presented.

The problem is, of course, that many of this country's corporations are incorporated in states where they neither do substantial business nor have substantial numbers of shareholders. Whether viewed from the standpoint of the constitutional text, precedent, or policy, it cannot *per se* violate the Commerce Clause for a state to regulate the "internal affairs," or in particular the shareholder voting rights, of a corporation that is

⁹ 107 S. Ct. at 1649.

¹⁰ 531 A.2d 206, 217 (Del. 1987) [hereinafter *McDermott*]. The *McDermott* court held that Panamanian law governed the voting rights of a Delaware subsidiary that held shares in its parent company, a Panamanian corporation. *Id.* at 218-19.

¹¹ 679 F. Supp 1022, 1033 (W.D. Okla. 1987). In *Telex*, the court held on a preliminary injunction motion that Oklahoma's control shares statute, OKLA. STAT. tit. 18, §§ 1145-55 (1988), was unconstitutional as applied to foreign corporations. *Id.*

¹² See also *Hyde Park Partners v. Connolly*, 839 F.2d 837, 844 (1st Cir. 1988) (dictum) (drawing the same conclusion); Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CALIF. L. REV. 29, 34-35 (1987) (noting the Supreme Court's strong suggestion of this conclusion in *CTS*).

¹³ All *CTS* says is that the Indiana statute, even if adopted in every state, would create no risk of conflicting state laws, and thus poses no "inconsistent regulations" problem whatsoever. That proposition is simple enough. It does not follow, however, that any statute which (if adopted in every state) *would* create a risk of conflicting state laws *necessarily* violates the Commerce Clause. As *CTS* itself acknowledges, a risk of conflicting regulations may yet be "permissible" under the Commerce Clause. 107 S. Ct. at 1649.

¹⁴ See *infra* Part II.

nominally foreign, but that has its most substantial business and shareholder contacts with the regulating state.

II. THE COMMERCE CLAUSE: "INCONSISTENT REGULATIONS" VERSUS CONFLICTS OF LAW

The critical language in *CTS* is the Court's statement that the Commerce Clause may invalidate statutes that "subject[] activities to inconsistent regulations."¹⁵ A reader might suppose that this formulation referred to some well-established Commerce Clause principle to the effect that a state law is invalid if it potentially subjects an actor in interstate commerce to simultaneous, but conflicting, legal obligations. The Commerce Clause, it might be thought, provides a federal remedy for commercial actors caught between conflicting state laws. Indeed, the *Telex* court went still further, stating that the Commerce Clause not only invalidates laws that *actually* subject commerce to conflicting regulations, but also laws that simply create the *risk* of such conflicts in that other states might pass regulations inconsistent with the law at issue at some future time.¹⁶

In fact, a moment's reflection reveals the falsity of this reasoning. Nothing is more common than the subjection of interstate commerce to conflicting state laws. It would be absurd to say, for example, that New York contract law violates the Commerce Clause to the extent it subjects out-of-state transactions to regulations inconsistent with the law of the state in which the transaction takes place. New York applies its law of contracts to out-of-state transactions every day, even when its law directly conflicts with that of the locus state. And why, for that matter, would we invalidate the New York law rather than the other state's law even if a Commerce Clause problem *were* presented? The fact is that there has never been, and could not be, any general Commerce Clause principle prohibiting the conflict of laws. Instead, there is a field of jurisprudence—the conflict of laws, of course—that is meant to resolve such difficulties.

Now, at least until *MITE* and *CTS*, the internal affairs doctrine was understood to be a rule emanating out of conflicts-of-law jurisprudence. Where questions arose concerning which state's law was to govern a controversy involving a corporation, the internal affairs doctrine would be trotted out to help provide an answer. It must be understood at the outset that the Supreme Court has *never* held that the Commerce Clause requires states to follow any particular choice-of-law rule. If there were a constitutional provision with this effect, it should be (one would think) the Full Faith and Credit Clause, which is more or less expressly directed

¹⁵ 107 S. Ct. at 1649.

¹⁶ *Telex*, 679 F. Supp. at 1031.

to interstate conflicts of law.¹⁷ And although for a time, several decades ago, the Court appeared to have held that this Clause did indeed constitutionalize the internal affairs doctrine,¹⁸ it is now settled that Full Faith and Credit imposes only minimal restrictions on a state choosing to apply its own law to a given controversy.¹⁹

By contrast to Full Faith and Credit analysis, the "inconsistent regulations" branch of Commerce Clause analysis has ultimately concerned conflicts between *state and federal* regulatory power. To be sure, the "inconsistent regulations" involved in Commerce Clause cases have been *interstate* inconsistencies: numerous decisions have struck down state laws under the Commerce Clause that conflicted with, or could have conflicted with, the laws of other states.²⁰ Nevertheless, *none of these cases was a choice-of-law case*; none was a case in which one state's law had to be chosen over that of another.

¹⁷ In fact, before *MITE*, studies of the foreign corporations problem almost invariably discussed only the Due Process and Full Faith and Credit Clauses as the possible constitutional pegs on which the internal affairs rule *might* be hung. See, e.g., Baraf, *The Foreign Corporation: A Problem in Conflict of Laws Doctrine*, 33 BROOKLYN L. REV. 219, 237-47 (1966); Coleman, *Corporate Dividends and the Conflict of Laws*, 63 HARV. L. REV. 433, 457-67 (1950); Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433, 445-60 (1968); Latty, *Pseudo-Foreign Corporations*, 65 YALE L. J. 137, 162-66 (1955); Reese & Kaufman, *supra* note 3, at 1129. But see Horowitz, *The Commerce Clause as a Limitation on State Choice-of-Law Doctrine*, 84 HARV. L. REV. 806, 826 (1971). Indeed, hornbooks on conflicts of law occasionally omitted the Commerce Clause altogether when discussing potential constitutional limitations on choice-of-law doctrine. See, e.g., E. SCOLE & P. HAY, *CONFLICT OF LAWS* 79-110 (1982) (considering the implications of the Due Process, Full Faith and Credit, Privileges and Immunities, and Equal Protection Clauses).

¹⁸ See, e.g., *Broderick v. Rosner*, 294 U.S. 629, 643-44 (1935).

¹⁹ Under the modern view of the Full Faith and Credit Clause, a state may apply its own law to a controversy provided only that it has "significant contacts" with the matter at issue. See *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821 (1985). It is worth noting that the Delaware Supreme Court, while acknowledging some "uncertainties" on the subject, nevertheless argued in *McDermott* that the old *Broderick* line of cases was still good law. See *McDermott*, 531 A.2d at 218. The court failed, however, to cite *Phillips* which, by adopting the "significant contacts" test, plainly delivered the final blow to the old-line Full Faith and Credit doctrine that had very nearly constitutionalized traditional (i.e., pre-interest analysis) conflicts law. See also *Allstate Ins. Co. v. Hague*, 449 U.S. 302 (1981); see generally Buxbaum, *supra* note 12, at 43-44, 47-50 (discussing the weakening of Full Faith and Credit doctrine in the corporation law context); Kaplan *supra* note 17, at 445-48.

²⁰ See, e.g., *Kassell v. Consolidated Freightways Corp.*, 450 U.S. 662 (1981) (invalidating 55-foot limit on truck lengths); *Bibb v. Navajo Freight Lines*, 359 U.S. 520 (1959) (invalidating certain truck mudguard regulations); *Morgan v. Virginia*, 328 U.S. 373 (1946) (invalidating requirement of racial segregation on buses); *Southern Pac. Co. v. Arizona*, 325 U.S. 711 (1945) (invalidating limitation on train lengths); *Kelly v. Washington*, 302 U.S. 1 (1937) (invalidating certain regulations on ship design and operation); *South Covington & Cincinnati St. Ry. Co. v. Covington*, 235 U.S. 537 (1915) (invalidating limitation on number of passengers to be carried in train cars); *Hall v. DeCuir*, 95 U.S. 485 (1877) (invalidating requirement of equal accommodation for blacks on steamboats).

Take *Morgan v. Virginia*,²¹ which, despite somewhat off-color facts, is a prototypical inconsistent-regulations Commerce Clause case. There, the Supreme Court struck down Virginia's statute requiring motor carriers to segregate black and white passengers. (The ground of invalidation was not the fourteenth amendment, but the Commerce Clause.) Other states had laws *forbidding* racial segregation of passengers. The effect of this inconsistency was that passengers "must if necessary repeatedly shift seats" at state borders²² and that carriers were burdened by a "crazy-quilt . . . of contradictory and confusing State laws."²³ The Court held that a "single, uniform rule" was necessary in this area "to promote and protect national travel."²⁴ The Court struck down Virginia's law on the ground that *Congress alone* had authority to regulate in this area.

The difference between cases such as *Morgan v. Virginia* and a choice-of-law case is plain. In a choice-of-law case, two or more states' laws are *simultaneously* competing for application to a single controversy. The conflict is resolved by choosing one state's law or another's as the sole applicable law. By contrast, as *Morgan* exemplifies, in the Commerce Clause "inconsistent regulations" cases, the laws of more than one state would have applied not simultaneously, but each in turn. The problem is caused by the peculiarly ambulatory nature of commerce: carriers may be unable practicably to accommodate the inconsistent laws even though never subject to *simultaneously* conflicting obligations.

The solution in these cases is *not*, therefore, a matter of choosing and applying one state's law. There was no question in *Morgan* of applying *another state's law* to carriers passing through Virginia. Nor was there any question of establishing nationwide uniformity by holding that the law of any particular state was alone applicable throughout the country. When the Court held Virginia's statute unconstitutional under the Commerce Clause, it was saying that only a federal, congressional law, could be applicable. The inconsistency among state laws in *Morgan* was a Commerce Clause question only because it implicated a conflict between state and *federal* regulatory power.

What *Morgan* illustrates is a simple, essential rule of Commerce Clause analysis: the *uniformity* interest underlying that clause is not to be achieved, or at least has never in the past been achieved, by holding that one state's law is applicable throughout a region or throughout the entire nation. If a state threatens to subject commerce to regulations inconsistent with those of other states, and if the need for uniformity is great enough, state law may have to yield to *federal* regulatory power.

²¹ 328 U.S. 373 (1946).

²² *Id.* at 381.

²³ *Id.* at 388 (Frankfurter, J., concurring).

²⁴ *Id.* at 386.

The principle, as the *Morgan* Court put it, is this: "Where uniformity is essential for the functioning of commerce, a state may not interpose its local regulation."²⁵ Thus the conflict is never resolved by holding that the law of one state is supreme under the Commerce Clause with respect to other states' laws. The holding is that *no* state can regulate the subject matter in question. The Commerce Clause, in its inconsistent regulations branch, applies to conflicts not between state laws per se, but between state and federal regulatory power.²⁶

No such state/federal conflict arises out of a control shares statute. Or rather, to the extent that a state/federal conflict is presented in this context, *CTS* has made it absolutely clear that *state* law can and will govern corporate share voting rights.²⁷ The only question is *which* state's law is to govern. And that is a choice-of-law question, not a Commerce Clause question.

To restate the argument: It is plain that with respect to a *particular* corporation's self-governance in the face of a tender offer, one law alone must have nationwide effect. But this need for a single applicable state law forces us simply to decide a choice-of-state-law question. It is not the need for a uniform, nationwide rule of law that would force us to decide against any state regulation of the matter. Or at least, *CTS* has squarely confronted that issue and decided in favor of state law. The situation would be different if an inconsistency among *different* corporations' self-governance rules created special burdens on interstate commerce. If there were some need for nationwide uniformity of shareholder voter rights as among *all corporations generally*, then the Commerce Clause

²⁵ *Morgan v. Virginia*, 328 U.S. 373, 377 (1946). This principle derives from *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299, 319 (1852) (holding that the Commerce Clause prohibits states from regulating matters that "are in their nature national, or admit of one uniform system, or plan of regulation.").

²⁶ Most of the "inconsistent regulations" cases, see *supra* note 20, fit the very same mold as *Morgan*. That is, their essential holding was that *no state* could constitutionally regulate the subject matter at issue. In some of the relatively more recent cases, however, such as *Kassell* and *Bibb*, the Court has struck down transportation regulations inconsistent with those of other states on the ground that the law served no real safety purposes and (because of its inconsistency with the laws of surrounding states) imposed excessive burdens on the movement of goods. These cases differ from the first line because the holding is *not* that states are precluded entirely from regulating the subject matter at issue. They are similar, however, in that no choice-of-law issue was presented. That is, the Court was not faced with a question of applying one state's law *as opposed* to another's and did not hold that uniformity was to be achieved by making one state's law the national rule for any particular actor (as would be the case if it were held that only the incorporating state could constitutionally regulate a corporation's voting rights). Because these cases essentially turn on a balancing of the benefits and burdens of the state law at issue, they are better understood as part of the "excessive burdens" branch of Commerce Clause analysis, rather than as part of a separate "inconsistent regulations" branch. The "excessive burdens" test as applied to the regulation of foreign corporations is considered in Part III(C) *infra*.

²⁷ *CTS v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1650 (1987).

might well be invoked to displace all state law (with respect to this issue) in favor of a federal regulatory power. But the need for a single governing law as to *one* corporation's shareholder voting rights is very different from the need for a single uniform law as to *all* corporations' shareholder voting rights. In the former case there is no question of displacing state law in favor of federal legislative authority, but simply of choosing one state's law or another's.

The Commerce Clause has, in fact, *almost never* been held to displace one state's law in favor of another state's law.²⁸ And by its own terms, how could it? Surely the Commerce Clause, as a grant of power to the federal government, can displace state law only in favor of the federal power to regulate. How can a pure choice between state laws implicate the Commerce Clause?

III. OBJECTIONS AND ANSWERS: THE OTHER BRANCHES OF COMMERCE CLAUSE ANALYSIS

Doubters will doubtless say that although most choice-of-law issues are foreign to the Commerce Clause, regulation of corporations may be a different case. There are a number of ways to support this claim, each drawing on other branches of Commerce Clause analysis.

²⁸ An exception might arguably be *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 106 S. Ct. 2080 (1986). *Brown-Forman* involved a New York law that required liquor distillers to post the prices they would charge New York wholesalers during the upcoming month and made it unlawful to charge *out-of-state* wholesalers a lower price during that month. The Court held the law unconstitutional as a "direct" regulation of interstate commerce. *Id.* at 2086. There are hints, however, in the Court's opinion that one of the bases of its decision was the possibility that the law might render illegal an act *required* by another state's law. *See id.* at 2087. This language might be said to imply that a statute creating the possibility of such a conflict violates the Commerce Clause and must give way to the law of other states.

The latter, however, cannot be the ground of *Brown-Forman* because it makes no sense. Why did the New York law have to give way rather than the other state's law—because it was the law first challenged? As noted in the text above, states constantly subject commercial conduct to conflicting laws. This situation cannot without more amount to a Commerce Clause violation.

A more coherent rationale for *Brown-Forman* is that New York was regulating acts of interstate commerce as to which it had no legitimate interest. New York could perhaps penalize liquor distillers if they failed to offer New York wholesalers the same price they offer out-of-state wholesalers; but in principle New York has not interest in the seller's mere act of offering his products at a lower price elsewhere. *Cf. Regan, Siamese Essays: (I) CTS Corp. v. Dynamics Corp. of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation*, 85 MICH. L. REV. 1865, 1902-04 (1987) (arguing that *Brown-Forman* is to be explained not by reference to the Commerce Clause, but to an implicit constitutional prohibition against completely extraterritorial state legislation).

As to the argument that a state has no actual, legitimate interest in the internal affairs of a foreign corporation, see *infra* Parts III(C) and IV(B).

After all, the Commerce Clause addresses more than "inconsistent regulations." It also prohibits states (according to the various formulations used from time to time) from "directly" regulating interstate commerce,²⁹ "discriminating" against interstate commerce,³⁰ or imposing "excessive burdens" on interstate commerce.³¹ An argument can be made from each of these branches of Commerce Clause analysis that a control shares statute regulating "foreign" corporations would be unconstitutional. None of these arguments seems ultimately persuasive.

A. *Direct Regulation of Interstate Commerce*

Most choice-of-law questions, it might be said, do not "inherently" implicate interstate commerce the way that regulation of a foreign corporation does. A tender offer is a nationwide transaction, inviting a transfer of corporate securities all over the country. If Oklahoma regulates corporate voting rights in a tender offer for shares of a Delaware corporation, isn't Oklahoma "directly" regulating interstate commerce?

The notion of "direct" as opposed to "indirect" regulation of interstate commerce is probably so elastic that it cannot be analytically useful. In fact, at least until quite recently, most modern commentators believed that Chief Justice Stone had done away with the direct/indirect branch of Commerce Clause analysis almost a half century ago.³² Nevertheless, the Court apparently resurrected the direct/indirect distinction in the recent Commerce Clause case of *Brown-Forman Distillers, Inc. v. New York State Liquor Authority*.³³ Thus for good or ill, the "direct regulation" doctrine seems still to be with us.

There is, however, a logical flaw in attempting to apply that doctrine here, even assuming *arguendo* that direct regulation is involved. Where the Supreme Court has struck down a law as a direct regulation of interstate commerce, the holding has of course been that *no state* could

²⁹ *E.g.*, *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 106 S. Ct. 2080 (1986). The vitality of the "direct regulation" doctrine is open to question. *See infra* Part III(A).

³⁰ *E.g.*, *CTS*, 107 S. Ct. at 1648-49; *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 36-37 (1980). *See infra* Part III(B).

³¹ This test is usually identified with the case of *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). *See infra* Part III(C).

³² *See* *DiSanto v. Pennsylvania*, 273 U.S. 34, 44 (1927) (Stone, C.J., dissenting) (in "making use of the expressions, 'direct' and 'indirect interference' with commerce, we are doing little more than using labels to describe a result."). Chief Justice Stone's view, supported by influential commentary, appeared to have prevailed when he wrote the Court's opinion in *Southern Pac. Co. v. Arizona*, 325 U.S. 761 (1945). *See generally*, 1 R. ROTUNDA, J. NOWAK & J. YOUNG, *CONSTITUTIONAL LAW—SUBSTANCE AND PROCEDURE* §§ 11.6-11.7 (1986).

³³ 106 S. Ct. 2080, 2084, 2087 (1986). *But cf.* *Arkansas Elec. Corp. v. Arkansas Pub. Comm'n*, 461 U.S. 375, 380 (1983) (disparaging the "supposedly precise division between 'direct' and 'indirect' effects on interstate commerce.").

constitutionally make such a law. The reason is, once again, that the Commerce Clause is in this line of analysis addressed to conflicts between state and federal regulatory power: if a law “directly” regulates interstate commerce, the argument goes, only the federal government has the power to enact it. When it comes to a control shares statute, however, some state is going to be “directly” regulating interstate commerce, whether it be the state of incorporation or another state. In short, *CTS* stands as a square rejection of the idea that a control shares statute “directly” regulates interstate commerce.³⁴

It might be suggested that the incorporating state would not be subject to this charge because the corporate shares are always somehow “situated” in the incorporating state; hence, in regulating such shares, Delaware, for example, would always be primarily regulating Delaware commerce. But no one has accepted the *situs* view of corporate shares since *Shaffer v. Heitner*.³⁵ If Delaware regulates a nationwide tender offer for the shares of a corporation, Delaware is regulating interstate commerce; this regulation cannot seriously be called less “direct” if the corporation at issue happens to have been chartered in Delaware.³⁶

Moreover, an objection to the extraterritorial scope of a control shares

³⁴ See *CTS v. Dynamics Corp. of Am.*, 107 S. Ct. 1637 (1987) (“[L]aws [regulating corporate governance] necessarily affect certain aspects of interstate commerce. This necessarily is true with respect to corporations with shareholders in states other than the state of incorporation.”). See also *Hyde Park Partners v. Connolly*, 839 F.2d 837, 845 (1st Cir. 1988) (stating that the *CTS* “majority opinion *sub silentio* dismisses the ‘direct restraint’ *per se* test.”).

³⁵ 433 U.S. 186 (1977).

³⁶ This assertion is borne out by Justice White’s plurality opinion in *MITE* and dissenting opinion in *CTS*. Justice White argued that the statutes in both cases were “direct” regulations of interstate commerce and therefore invalid. See *Edgar v. MITE Corp.*, 457 U.S. 624, 642 (1982) (plurality opinion); *CTS*, 107 S. Ct. at 1654-55 (White, J., dissenting). Justice White’s opinions are at least consistent: if the direct/indirect analysis is to be applied to state takeover legislation, it makes no difference whether the statute applies to foreign corporations, as in *MITE*, or only to domestic ones, as in *CTS*. Both would be invalid.

It might be argued, however, that Delaware has a legitimate *interest* in regulating the shares of its corporations, no matter where they are held, but that no other state has an interest in regulating these shares anywhere outside of that other state’s borders. This argument is no longer raising a “direct regulation” challenge, but rather a challenge to the regulating state’s interests in the legislation. This challenge is dealt with below. See *infra* Part III(C).

It might also be said that what saves a control shares statute from the charge of “direct” regulation is that a control shares statute merely regulates the voting rights that the shares carry, rather than prohibiting the actual sale of the shares: while a prohibition of transfers of shares would be a “direct” regulation of interstate commerce (this argument goes), the regulation of *voting rights* is not. One hopes, of course, that the Supreme Court was not relying on a distinction so fictitious as this in *CTS*. In any event this point is irrelevant to the discussion here. If this fiction were the saving feature, it would equally save control share statutes directed at both domestic and foreign corporations.

statute proves far too much: the same objection could be made in other contexts where no constitutional problems have ever been thought to exist. Consider contract law. As noted earlier, New York will frequently apply its law to contracts executed and even performed in part elsewhere, so long as the contract has substantial ties to New York. Indeed, New York might even condition the assignment of rights or delegation of duties under a contract executed out of state on the consent of parties who are New York residents (as well, perhaps, as other parties who are not). That situation would be, in certain respects, exactly analogous to that of a control shares statute applied to foreign corporations. Yet no one has ever seriously contended that New York contract law (or the traditional choice-of-law rule permitting New York to give its law extraterritorial effect) violates the Commerce Clause as a "direct" regulation of interstate commerce.³⁷

The troublesome fact is that some matters traditionally left to state law are predominantly interstate in fact, yet jurisdictionally indivisible in nature. By "jurisdictionally indivisible," I mean that the law of only one jurisdiction may practicably be applied, even though the transaction takes place across jurisdictions. In these circumstances, inevitably one state's law must receive extraterritorial application. The assignment of a contract may sometimes be one such matter; corporate governance may sometimes be another.

These matters cannot be divided like the movement of a train or bus through various states, where each state's law may apply in turn. One law alone must govern, yet they remain primarily interstate in their real, practical effects. The Commerce Clause could be held to disable any state from regulating such matters on the ground that only a single, federal rule should apply. But this has never been the law; nor will it be the law so long as we have a system in which primary rights and duties, whether

³⁷ Professor Regan argues in his "twin" essays on *CTS* and extraterritoriality, *see supra* note 28, that the real holding of *CTS* is that the event comprising the transfer of control of a corporation "occurs in" the incorporating state, which thus alone has power to regulate it. *See Regan, supra* note 28, at 1875-77. His analysis makes "extraterritoriality" the critical element of unconstitutionality. Regan never confronts, however, the manifest extraterritoriality of ordinary contract (or tort) law as applied to out-of-state conduct that has certain in-state contacts or effects. To insist that in every such case, the regulated event (perhaps as basic an event as the sale of goods known to be headed for another state) "occurred" in the state whose law is eventually applied is analytically without value. It would be a completely conclusory statement that presupposed some other, more substantial inquiry, probably having to do with "contacts" or "connections" with the regulating state—*i.e.*, the ordinary choice-of-law and due process concerns. Thus, for example, Regan's argument for the internal affairs rule begs the question: why should we say that corporate transfers of control occur in the state of incorporation rather than in the state of the corporation's "real" (*i.e.*, business) domicile? Regan's answer—that the incorporating state alone has a "connection" to the "legal identity and ownership" of the corporation—is patently circular. *Id.* at 1899.

in tort, contract or corporation law, are defined largely by the states. An Oklahoma control shares statute applicable to nominally "foreign" corporations regulates interstate commerce no more or no less (and certainly no more or no less "directly") than traditional contract law in some situations or than a Delaware control shares statute applicable solely to "Delaware" corporations.³⁸ The only question is which state's law is to govern.

B. Protectionist Legislation

The implied limitations on state power found in the Commerce Clause are perhaps most centrally concerned with state laws that protect local commercial interests at the expense of free interstate trade.³⁹ It might be thought that a state, attempting to hinder corporate takeovers primarily in order to protect local business communities, is guilty of this protectionist charge. The Supreme Court has made clear, however, that so long as a law applies "evenhandedly" to in-state and out-of-state actors, it will not be held to violate the Commerce Clause on this ground.⁴⁰ As the Court noted in *CTS*, a voting rights statute of the sort discussed here may not constitutionally favor in-state over out-of-state acquirors, but if the law avoids this flaw, however, it cannot be said to discriminate against interstate commerce.⁴¹

C. Burdening Interstate Commerce

The Supreme Court stated in *Pike v. Bruce Church, Inc.*, that local laws violate the Commerce Clause if they impose burdens on interstate commerce "clearly excessive" in relation to the local interests served.⁴² This balancing test, which Justice Scalia so sharply criticized in *CTS*,⁴³ requires somewhat lengthier consideration.

1. The Balancing Test Absent Choice-of-Law Concerns

Putting aside, temporarily, all choice-of-law difficulties, it seems plain that under *CTS* a control shares statute directed at foreign corporations with substantial in-state contacts must survive the *Pike v. Bruce Church, Inc.* test. The reason is that (absent choice-of-law questions) the burdens

³⁸ See Coleman, *supra* note 17, at 460 (pointing out that regulations of foreign corporations cannot be unconstitutional solely because of their "extraterritorial effect").

³⁹ See *CTS v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1648 (1987) ("The principal objects of dormant Commerce Clause scrutiny are statutes that discriminate against interstate commerce.").

⁴⁰ *E.g.*, *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 471-72 (1981).

⁴¹ 107 S. Ct. at 1649.

⁴² 397 U.S. 137, 142 (1970).

⁴³ *CTS*, 107 S. Ct. at 163 (Scalia, J., concurring).

on interstate commerce are identical to those imposed by the statute upheld in *CTS*, while the benefits are no less substantial.

A control shares statute is designed to prevent a tender offer from succeeding when a majority of shareholders choose to reject it. That effect on commerce is not necessarily a "burden" at all; assuming that such a tender offer would otherwise have "coerced" unwilling shareholders into selling their shares, there are good reasons for calling it a *benefit* to interstate commerce. This aspect of the consequences of a control shares statute may explain why the Supreme Court in *CTS* did not consider the burdens on commerce to be particularly heavy.

Certainly one could find economists who would disagree with this view. Moreover, a control shares statute may also have effects on interstate commerce that would clearly constitute burdens: it might delay the consummation of tender offers for a few weeks, it might make tender offers slightly more costly, and it might arguably deter the initiation of some tender offers that shareholders would have willingly accepted. The point, however, is that any control shares statute will have these effects. It makes no difference in this respect whether Delaware or Oklahoma is the regulating state. Thus the interstate burdens of a control shares statute will be identical whether or not it applies to foreign corporations.

As for benefits, *CTS* is less dispositive because the local interests at stake are not identical with regard to the regulation of foreign as opposed to domestic corporations. It seems hardly open to doubt, however, that a state having the preponderant business and shareholder contacts with a corporation has at least as great an interest in protecting that corporation from a coercive takeover as does the state whose only contact with the corporation is the chartering document.

It is true that *CTS* noted the interest a state has in governing the operations of those corporations it has "created."⁴⁴ But if we strip away the metaphorical gauze surrounding that notion, what interest does the incorporating state actually have? Its interest lies in defining its corporations law in the manner most conducive to in-state incorporation or investment. This can be a considerable interest indeed, as Delaware has taught us again and again. But another state will have an equally considerable interest in defining its foreign corporations law in the manner most conducive to doing business and investing in that state. In addition, the protection of existing business communities is arguably an even stronger interest.⁴⁵ Finally, the protection of resident shareholders

⁴⁴ 107 S. Ct. at 1649-50.

⁴⁵ See, e.g., *Edgar v. MITE Corp.*, 457 U.S. 624, 646 (1982) (Powell, J., concurring in part). It should be noted that Justice Powell's concurrence in *MITE* provided the necessary fifth vote for the *MITE* majority.

is undeniably an independent, substantial and legitimate state interest.⁴⁶

If in *CTS* the Court had stressed the gravity of the burdens imposed by a control shares statute, but had found that the local interests in that case were so compelling that they outweighed even these substantial burdens, the situation might be different. The language in *CTS*, however, is of an entirely milder character. The Court referred to the paucity of evidence indicating that the Indiana statute would actually inhibit tender offers.⁴⁷ It spoke of the "limited extent [to which] the Act affects interstate commerce."⁴⁸ And the Court's discussion of the Indiana Act's benefits primarily serves to defend the modest proposition that Indiana was furthering a legitimate interest,⁴⁹ not an interest *so compelling* that it would outweigh serious impediments to commerce. No one can doubt that a state has a legitimate interest in protecting a corporation's local business relations and resident shareholders, even if the corporation is nominally a "foreign" one.

An objection to the foregoing could be made by invoking certain language of Justice White's from the majority opinion in *Edgar v. MITE Corp.*:

While protecting local investors is plainly a legitimate state objective, the state has no legitimate interest in protecting nonresident shareholders. Insofar as Illinois law burdens out-of-state transactions, there is nothing to be weighed in the balance to sustain the law.⁵⁰

Putting this language together with the holding in *CTS*, the *Telex* court reasoned that a state *does* have an interest in protecting nonresident shareholders of its *own* corporations, but no such interest with regard to nonresident shareholders of *foreign* corporations.⁵¹ The objection, then, is that a control shares statute applicable to foreign corporations must violate the *Pike v. Bruce Church, Inc.* test because, with respect to out-of-state shareholders who are clearly burdened, "there is nothing to be weighed in the balance to sustain the law." This reasoning, perhaps appealing on the surface, unravels altogether upon inspection.

First, it begs the question. One real issue at stake here is ultimately

⁴⁶ See *CTS v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1652 (1987).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 1651-52.

⁵⁰ 457 U.S. 624, 644 (1982).

⁵¹ See *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022, 1031 (W.D. Okla. 1987); see also *McDermott v. Lewis*, 531 A.2d 206, 217 n.12 (Del. 1987) (making a similar argument). Actually, Justice White pretty clearly meant his language to encompass even nonresident shareholders of *domestic* corporations (as was the case in *MITE*).

whether the corporation “belongs,” at least for this particular purpose, more to the incorporating state or to the state in which it does its principal business. If the latter, then Oklahoma can claim just as much of an interest as Delaware in protecting nonresident shareholders.

Second, Justice White’s language is in any event quite puzzling. There certainly *is* something to be weighed in the balance against the law’s out-of-state burdens: namely the *in-state* benefits. Justice White cannot be saying that a statute’s burdens on out-of-state transactions may be offset only by benefits *to* out-of-state transactions. That would be absurd; virtually every state law placing a burden on interstate commerce would fail that test. The whole point of *Pike v. Bruce Church, Inc.* (for good or ill) is that courts must weigh the *local* benefits against the out-of-state burdens.⁵² The better interpretation of Justice White’s language is that he meant to say that a state has no interest in protecting *only* nonresident shareholders. (He noted elsewhere in his opinion that the statute at issue in *MITE* could apply even if there were *no* resident shareholders.)⁵³ As the Court said in *CTS*, so long as the statute in question applies only to corporations meeting significant resident shareholder requirements, “every application of the [statute] will affect a substantial number of [state] residents, whom [the state] indisputably has an interest in protecting.”⁵⁴

Another way of stating what is really the essential point is that a state is not necessarily forbidden to protect nonresidents *if doing so is the only way under the circumstances to protect residents as well*. That is why the Commerce Clause does not (for example) prevent a local government from enforcing pollution standards against ships passing through the locality, even when the ships must replace their engines in order to comply so that the local government is in effect imposing its own pollution standards outside the jurisdiction as well as inside it.⁵⁵ The local law may be such that it will invariably protect nonresidents as well, but—with all respect to Justice White—that fact alone cannot possibly render it invalid. In the case of corporate governance in general and shareholder voting rights in particular, protecting nonresident shareholders is often an indispensable part of protecting resident shareholders as well.

Thus, absent the choice-of-law issues, a control shares statute applica-

⁵² This basic point seems to have been missed by some commentators as well. See, e.g., Kozyris, *supra* note 3, at 40 (arguing that Justice White’s view “leaves *nothing* to be placed in the constitutional balance under the test of *Pike v. Bruce Church, Inc.*, to justify *any* state interference in the internal affairs of ‘foreign corporations’”) (original emphasis) (footnote omitted).

⁵³ *Edgar v. MITE*, 457 U.S. 624, 642 (1982).

⁵⁴ *CTS v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1652 (1987).

⁵⁵ See *Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440, 441, 448 (1960).

ble to nominally foreign corporations with substantial in-state contacts fares no worse under *Pike v. Bruce Church, Inc.* than a similar statute applicable only to domestic corporations. Indeed in some cases, where the corporation has far less substantial contacts with the incorporating state, it almost certainly fares better. But there is another, completely distinct burden that must be considered: the uncertainty of the choice of law itself.

2. The Balancing Test as Affected by Choice-of-Law Uncertainty

This argument may well be the fundamental one. The real danger that some perceive in allowing states to regulate the internal affairs of foreign corporations is that commerce will not be able to bear the resulting choice-of-law uncertainties.⁵⁶ Indeed, the *Telex* court opined that such uncertainty could bring “tender offers to a sudden halt.”⁵⁷ And the Supreme Court in *CTS* expressed concern about the same problem.⁵⁸ This burden, it might be said, is what causes a foreign-corporations control shares statute to fail the Commerce Clause balancing test.

This argument is in fact quite a bit more novel and more difficult to articulate than its proponents suppose. No case seems ever to have held a law invalid under the Commerce Clause on the ground that it produces choice-of-law uncertainties. Such uncertainty has apparently never even been considered a Commerce Clause “burden” for purposes of the *Pike v. Bruce Church, Inc.* test.

Consider once more contract law, which, compared to corporation law, is of at least equal if not far greater importance to the flourishing of interstate commerce. Choice-of-law uncertainty abounds here. Yet no one suggests that the Commerce Clause requires a single, federal law of contracts or, much less, a general rule stating that (for example) the performance of a contract between Delaware citizens is to be governed by Delaware law. And even though a single contract is to be performed in all fifty states, no one supposes that New York would be violating the Commerce Clause if, having the most contacts with the contract, it applies its own law to an important, indivisible provision thereof.

It may be replied that interstate commerce has been able to assimilate choice-of-law uncertainty in contract law primarily because private parties are permitted to agree upon the applicable law. This is without doubt an important point. But the answer is that the same may be done and has been done with respect to corporations. Choice-of-law provisions

⁵⁶ See sources cited *supra* note 3.

⁵⁷ *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022, 1031 (W. D. Okla. 1987).

⁵⁸ *CTS*, 107 S. Ct. at 1650. See also *McDermott v. Lewis*, 531 A.2d 206, 218 (Del. 1987) (“[D]irectors, officers and shareholders [must] be given adequate notice of the jurisdiction whose laws will ultimately govern the corporation’s internal affairs.”).

in corporate charters occur occasionally, and the Supreme Court has explicitly held that charter provisions can govern the applicable law.⁵⁹ More important, virtually every state control shares statute, including those applicable to both domestic and foreign corporations, contains a provision permitting the directors or shareholders of a corporation to opt in or out of the statute's coverage. Thus the same devices that parties employ to smooth out the choice-of-law wrinkles in contract law are also available here.

The reason why state laws presenting conflicts problems have never been held to violate the Commerce Clause despite the burdens they impose on interstate business is at bottom straightforward: choice-of-law uncertainties result from the very structure of a multi-sovereign legal system, not from the law of any particular state. Laws with *extra-territorial* scope present obvious problems for a multi-jurisdictional system, but in the corporations context, as in contracts, at least one state's law *must* in some cases be accorded extraterritorial application.⁶⁰ Thus extraterritoriality itself is not at issue; the question is simply, once again, *which* state is to receive the extraterritorial privilege. And that, it would seem, is merely a choice-of-law problem which, like any other, is to be resolved either through state conflicts law or through private choice-of-law provisions. At the extremes there will always be constitutional choice-of-law limits imposed by the Due Process and Full Faith and Credit Clauses. But if choice-of-law difficulties are the sole issue, the Commerce Clause, it would seem, has little to do with it.

Nonetheless, it seems wise to try to evaluate the predictions of chaos and doom made by adherents of the internal affairs doctrine. These predictions, it will be seen, tend to overlook reality in a number of respects.

First, it should be stressed that the thesis advocated here is by no means a wholesale rejection of the internal affairs doctrine. To the contrary, all that is at issue here is an exception to the doctrine where the incorporating state has few if any real ties to the corporation, and where another state has very substantial business and shareholder contacts with the corporation. If a control shares statute covered only those foreign corporations with which the legislating state could claim to have the most substantial business contacts (as well, perhaps, as a significant number of resident shareholders), then potential for conflicts would be minimized.⁶¹ The only possible conflicts arising out of every state adopting such a

⁵⁹ See, e.g., *Pinney v. Nelson*, 183 U.S. 144 (1901).

⁶⁰ See *CTS v. Dynamics Corp. of Am.*, 107 S. Ct. at 1650 (1987); *supra* Part III(A).

⁶¹ For example, North Carolina's control shares statute applies only to those foreign corporations having their principal place of business, at least 40% of their "fixed assets," at least 40% of their employees and at least 10% of their shareholders in North Carolina. See N.C. BUS. CORP. ACT § 55-90(b)(5) (Supp. 1987).

statute would be (1) occasional disputes about where the corporation's true business domicile was,⁶² and (2) conflicts between the "business" state and the incorporating state. This situation is a far cry from the "chaos" pictured by the *Telex* court in which some nineteen states were said to be able simultaneously to claim similar authority to regulate a corporation's internal affairs. And when conflicts between two or three states did arise, ordinary choice-of-law "interest analysis" or private choice-of-law provisions would be available to resolve the matter.

If we keep our sights fixed on conflicts between the incorporating state and the one or two other states able to claim some uniquely substantial business and shareholder contacts with the corporation, it becomes much easier to dispel any fears aroused by the relaxation of the internal affairs doctrine. A number of jurisdictions already subject corporations to this conflict, and commerce seems to be doing fine notwithstanding.

First, both New York and California have enacted laws explicitly making their domestic corporations code applicable to certain nominally foreign corporations. California's law applies to foreign corporations only if more than 50% of their shares are owned by California residents *and* they do more than 50% of their business (as computed by a specified set of tests) in the state as well.⁶³ Thus the California law squarely poses the problem of a conflict between the state of incorporation and the state of the corporation's business domicile. In addition, a third state could in theory assert a claim on the ground that it was the home of a greater *number* of individual shareholders (as opposed to a greater *percentage* of shares) and/or the corporation's principal place of business (perhaps using slightly different tests).

More than a decade has passed since California enacted its "pseudo-foreign corporations law." No debilitating consequences have yet occurred; commerce most certainly has not ground to a halt, and indeed no one has even reported serious difficulties arising from the law. New York

⁶² The term "principal place of business" is subject to various interpretations, as we know from federal court cases seeking to ascribe state citizenship to corporations under 28 U.S.C. § 1332(c) (1966). It has been argued that the "elusiveness" of the term for diversity jurisdiction purposes demonstrates that a business domicile test would be impracticable for choice-of-law purposes as well. See *Kozyris*, *supra* note 3, at 53. But there is no reason why the term "principal place of business" cannot simply be defined in such a way as to eliminate its "elusiveness." Courts or state legislatures may solve this problem by specifying a definition of "principal place of business" in this context, concentrating not on such criteria as location of executive offices, which have been employed in the diversity context, but on numerical percentages of assets, employees, and revenues located or derived in-state that would qualify the regulating state as having uniquely substantial business contacts with the target corporation. Or such percentages could be specified in addition to a "principal place of business" requirement. See *supra* note 58 (describing one such statute); see also CAL. CORP. CODE § 2115 (Deering 1977) discussed *infra* text accompanying notes 63-66.

⁶³ CAL. CORP. CODE § 2115 (Deering 1977).

has had a similar law on its books for almost 100 years⁶⁴ and the same is true there as well.

In fact there are very few decisions under these "pseudo-foreign corporations statutes" in either jurisdiction, which is perhaps the best testimony that the statutes do not pose serious problems for corporations or those doing business with them. As one commentator observed as far back as 1968, the spectre of "unbearable chaos and uncertainty," of which "the precise details . . . are seldom stated," has not materialized:

The contention of the Restatement and of other commentators that avoidance of confusion and difficulty makes it imperative to look to the law of the state of incorporation seems belied by the experience of New York. . . . [Although overlapping corporate regulations have] created a situation of theoretical conflict, the practical results have been accepted and viable, and the duplication of controls has resulted not so much in conflict as in cumulative standards.⁶⁵

The reason why things have gone so smoothly may simply lie in the overall similarity of the network of rules that various states impose on corporations. But a supporter of *Telex* and *McDermott* might well interpose a different reason: the New York and California statutes exempt from their coverage all corporations listed on national stock exchanges.⁶⁶ Thus the major, national corporations do not have to cope with the choice-of-law problems that the California and New York statutes might create.

There are, however, other states that do not adhere at all to the internal affairs doctrine, and look not to the law of the incorporating state but instead to the law of the state where the corporation has its principal place of business. These states are not American, but European. The business domicile rule is in fact the general choice-of-law rule for corporations throughout the Continent.⁶⁷ On the other hand, in England (as in America) the rule is *lex incorporationis*.⁶⁸ This potential conflict of corporation laws should have generated all the commercial pandemonium that some commentators have predicted. But the international economic community seems to be surviving the conflict without any

⁶⁴ See N.Y. BUS. CORP. LAW §§ 1315-20 (McKinney 1986). New York first passed laws specifically applicable to foreign corporations in 1897, precisely because of the problem engendered by the out-of-state incorporation of corporations otherwise based in New York seeking to escape New York regulation and taxation. See Coleman, *supra* note 17, at 447.

⁶⁵ Kaplan, *supra* note 17, at 476-77.

⁶⁶ New York did not permit this exemption, however, until the 1960's.

⁶⁷ See A. CONARD, CORPORATIONS IN PERSPECTIVE 15 (1976); see generally 2 E. RABEL, THE CONFLICT OF LAWS: A COMPARATIVE STUDY 33-68 (1960).

⁶⁸ See Kaplan, *supra* note 17, at 440.

serious problems—or at least there is no indication that its problems stem from corporation choice-of-law confusion.⁶⁹

There is a final, important point to be made. The worst case scenario conjured up by those opposed to the regulation of foreign corporations is corporate paralysis: faced with a multiplicity of inconsistent and potentially binding state laws, corporate actors, particularly directors and managers, will be able to take no action at all or, what is little better, will have to run into court for a declaratory choice-of-law judgment before taking any action. But this corporate paralysis scenario does not belong in a discussion of control shares statutes: the choice-of-law uncertainty that they produce does not principally afflict corporate directors or managers, but rather corporate acquirors. A control shares statute does not impinge upon general corporate operations or business transactions. To the limited extent that it affects directors or managers, they may eliminate all choice-of-law uncertainty by opting out of the statute's coverage.

It is pretty plain, in fact, that the only party who might really complain about the choice-of-law uncertainties is the acquiror. And *his* uncertainty has nothing to do with corporate paralysis; it is not the kind of uncertainty that adherents of the internal affairs doctrine are properly concerned about. His uncertainty in this field is no different than his uncertainty over the applicable law in any million or billion dollar transaction he might be contemplating. The cost of obtaining a declaratory choice-of-law judgment—if there were genuine choice-of-law uncertainty—would add to his expense only negligibly.⁷⁰ Indeed, sorting through the web of state and federal regulations applicable to much simpler transactions will be a good deal more complicated for him than resolving whether an Oklahoma control shares statute applies to his takeover of a Delaware corporation.

There is, however, a lingering sense that state regulation of foreign corporations does *not* present a choice-of-law problem “like any other.” There is a sense that choice-of-law uncertainty in this area might be particularly debilitating to national commerce. In addition, there is the alluring availability of a simple rule—the internal affairs doctrine—that would eliminate in one stroke all the potential difficulties. If any chance exists that the “free market”⁷¹ depends on choice-of-law certainty in the

⁶⁹ According to some commentators, however, the continental countries have lately begun to shift toward the rule of *lex incorporationis*. See, e.g., Kozyris, *supra* note 3, at 53-54.

⁷⁰ The acquiror could certainly initiate his tender offer first and then sue for a declaratory judgment while the offer was pending. Indeed acquirors *already* frequently initiate their offer first and then sue for a judgment invalidating those state laws that stand in their way.

⁷¹ *CTS v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1650 (1987).

field of corporate governance, or that uncertainty in this area would bring commerce to "a sudden halt,"⁷² would it not be wiser to avoid the risk and impose once and for all that simple rule?

It is of course questionable whether this last line of objection—appealing solely to simplicity and economic policy—amounts to a *constitutional* argument at all. But let us assume that it does. The question then becomes whether the internal affairs doctrine is really the simplifying and indispensable rule that its proponents claim it to be. Part IV of this article is an attempt to show that the internal affairs doctrine has never offered, and cannot offer, a coherent solution to the choice-of-law problems posed by state regulation of foreign corporations.

IV. THE PROBLEM WITH THE INTERNAL AFFAIRS DOCTRINE

The regulation of foreign corporations is by no means a new issue. The American legal system has been trying for centuries to accommodate the thorny interests implicated when corporations do business outside the state in which they were chartered. Predictably, the accommodation has not been very stable in its theory or practice.

A. *Two Conflicting Lines of Analysis*

The essential problem is that American corporations law has always sought to respect two lines of analysis that cannot at bottom be reconciled. First, because the image of a state "bringing corporations into being" has figured so prominently in our jurisprudence, it has always been understood that a corporation is to be governed primarily by the incorporating state. This idea was so strong that state courts used to refuse even to entertain some suits against a foreign corporation, on the ground that only the incorporating state had power to enforce judgments against it.⁷³ Simultaneously, however, it has always been equally well understood that a corporation had to obey the laws of each state in which it did business regardless of where it was incorporated. And on the theory that a state could exclude the corporation altogether if the state so chose, it followed (because the greater power was assumed to include the lesser) that a state could subject a foreign corporation to virtually any reasonable regulations as a condition of doing business there.⁷⁴

⁷² TLX Acquisition Corp. v. Telex Corp., 679 F. Supp. 1022, 1031 (W.D. Okla. 1987).

⁷³ See, e.g., North State Copper & Gold Mining Co. v. Field, 20 A. 1039, 1040 (Md. 1885). Indeed, the "internal affairs doctrine" originally referred to this doctrine of jurisdictional abstention, see Baraf, *The Foreign Corporation—A Problem in Choice-of-Law Doctrine*, 33 BROOKLYN L. REV. 219, 235-36 (1966), which in its extreme manifestations was later rejected by the Supreme Court. See *Williams v. Green Bay & W. R.R.*, 326 U.S. 549 (1946).

⁷⁴ See Kaplan, *supra* note 17, at 443.

Both these lines of thinking developed in contented ignorance of each other right up to their logical limits. Thus it is possible to find pre-modern Supreme Court cases holding both that states *violate the Constitution* when they attempt to apply their own corporations law to foreign corporations,⁷⁵ and that states may do with a foreign corporation *anything and everything* they do with domestic corporations.⁷⁶

The distinction drawn to accommodate these competing principles is, as described earlier, between the "internal affairs" of a corporation and its "external affairs." Regarding matters "peculiar to the corporation," as it is sometimes said, or matters affecting the relationships of corporate members or actors *inter se*, only the incorporating state has power to legislate. Insofar as the corporation had dealings with the "outside" world, however, the state in which these dealings took place has full regulatory authority.

If this distinction had really been adhered to, or if it even *could* have been, those insisting on the indispensability of the internal affairs doctrine would stand on much firmer ground. In fact, however, the internal affairs rule has often been rejected by the courts. These deviations from the rule undermine both the empirical claim at issue—that interstate commerce will be thrown into turmoil if the internal affairs doctrine is not rigorously enforced—and the theoretical foundations of the doctrine itself.

B. *The Problem with the Internal Affairs Doctrine*

The problem with the internal affairs doctrine is essentially the same as the problem with John Stuart Mill's doctrine of self-regarding acts: there are none. No corporate affairs are ever exclusively "internal"; they

⁷⁵ *E.g.*, *Broderick v. Rosner*, 294 U.S. 629 (1935). The Court's language is as broad as can be imagined:

The assessment [of shareholder liability] is an incident of the incorporation. Thus the subject matter is peculiarly within the regulatory power of New York, as the State of incorporation. . . . For 'as marriage looks to domicile, membership [in a corporation] looks to and must be governed by the law of the State granting the incorporation.'

Id. at 643-44 (quoting *Modern Woodmen of Am. v. Mixer*, 267 U.S. 544, 551 (1925)). This holding rested on an interpretation of the Full Faith and Credit Clause (not the Commerce Clause), which has subsequently been overruled. See *supra* note 19; *infra* text accompanying notes 98 & 99.

⁷⁶ *E.g.*, *Horn Silver Mining Co. v. New York*, 143 U.S. 305 (1892). The language used in such cases is equally broad:

Having the absolute power of excluding the foreign corporation the State may, of course, impose such conditions upon permitting the corporations to do business within its limits as it may judge expedient. . . . It does not lie in any foreign corporation to complain that it is subjected to the same law with the domestic corporation.

Id. at 315.

will always have consequences of greater or lesser magnitude on the "outside" world. If a corporation's internal affairs adversely affect shareholders, then a state in which a substantial number of those shareholders live will also be adversely affected. If they adversely affect the corporation's business or finances, then a state enjoying that business or finance will also be adversely affected. The spillover may be negligible, or the external effects may not be adverse but rather beneficial to everyone, in which case things will proceed happily for the internal affairs doctrine without choice-of-law questions ever arising. But as soon as harm is threatened—as soon, that is, as there is anything to which a non-incorporating state may, in practice, want to apply its law—choice-of-law questions immediately crop up, and if the state in question can claim more important ties to the corporation than the incorporating state, the internal affairs doctrine is suddenly cast away.

Consider the distribution of corporate dividends. No matter is more "peculiar to the corporation"; none more clearly involves corporate relationships *inter se*. Yet in certain circumstances, particularly when insolvency is at stake, the declaration of dividends will without doubt have serious "external" consequences. Thus, in what remains today the leading case on this point, Justice (then Judge) Cardozo wrote for New York's highest court that the state would not hesitate to apply its own law to a foreign corporation in such circumstances.⁷⁷ His words are worth quoting at length:

As long as a foreign corporation keeps away from this state it is not for us to say what it may do or not do. But when it comes into this state and transacts its business here, it must yield obedience to our laws. For many purposes the fiction of its residence in the state of its origin must then be disregarded. This statute makes no attempt to regulate foreign corporations while they keep within their domicile. . . . If they take the corporation out of [our] state, they may declare dividends as they please. If they elect to keep it with us, they must not lead it into paths of ruin. In these days, when countless corporations, organized on paper in neighboring states, live and move and have their being in New York, a

⁷⁷ *German-American Coffee Co. v. Diehl*, 216 N.Y. 57, 109 N.E. 875 (1915). The case presented a conflict between New York law, which permitted the corporation to sue its directors for declaring dividends improperly, and New Jersey law, which did not. The case does not squarely hold that New York law would govern the issue of the lawfulness of the dividends. *Id.* at 877 (reserving the question). The issue, however, of directors' liability to a corporation is, if anything, more "internal" an affair than that of a dividend's propriety. In any event, the language of the case (quoted in the text) is so strong that it virtually compels the conclusion that New York law would apply to the latter issue as well, and the case was later so construed. See *International Ticket Scale Corp. v. United States*, 165 F.2d 358 (2d Cir. 1948).

sound public policy demands that our Legislature be invested with this measure of control. If the control is irksome, it may be avoided by leaving us.⁷⁸

Other courts have repeatedly employed similar reasoning on such "internal" issues as reclassification of stock,⁷⁹ dissolution of the corporation,⁸⁰ standing to bring a derivative action,⁸¹ purchases by a corporation of its own stock,⁸² the issuance of new stock,⁸³ the standards of a majority shareholder's fiduciary duties,⁸⁴ and as in *German-American Coffee Co. v. Diehl*, the distribution of dividends.⁸⁵ Indeed, New York and California, as discussed earlier, have codified the holding of *German-American Coffee* into their statutory law.⁸⁶

Yet, perhaps it will still be said that at least as to *shareholder voting rights*, the matter regulated by a control shares statute, only the law of the incorporating state should apply. Here too, however, courts have applied the law of a state with more substantial contacts to the matter at issue than those of the incorporating state.⁸⁷

The first implication of the cases just described is that they provide further evidence that interstate commerce survives perfectly well even if

⁷⁸ 216 N.Y. at 64 (citations omitted).

⁷⁹ *E.g.*, *State ex rel. Weede v. Bechtel*, 239 Iowa 1298, 31 N.W.2d 853 (1948), *cert. denied*, 337 U.S. 918 (1949).

⁸⁰ *E.g.*, *Ficor, Inc. v. McHugh*, 639 P.2d 385, 391 (Colo. 1982).

⁸¹ *E.g.*, *Stephenson v. Landogger*, 337 F. Supp. 591, 593 (S.D.N.Y. 1971), *aff'd*, 464 F.2d 133 (2d Cir.), *cert. denied*, 409 U.S. 1039 (1972).

⁸² *E.g.*, *Mansfield Hardwood Lumber Co. v. Johnson*, 268 F.2d 317, 321 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959).

⁸³ *E.g.*, *Booth v. Scott*, 276 Mo. 1, 205 S.W. 633, *error dismissed*, 253 U.S. 475 (1918).

⁸⁴ *E.g.*, *Blazer v. Black*, 196 F.2d 139 (10th Cir. 1952).

⁸⁵ *International Ticket Scale Corp. v. United States*, 165 F.2d 358, 360 (2d Cir. 1948). In addition, the Supreme Court has itself held that one state may apply its own law to determine whether an act performed in that state by a resident of that state resulted in making him a shareholder of another state's corporation. *Pink v. A.A.A. Highway Express*, 314 U.S. 201 (1941). *See generally* Latty, *supra* note 17, at 150-55 (discussing cases that do not apply the internal affairs rule).

⁸⁶ *See* CAL. CORP. CODE § 2115 (Deering 1977); N.Y. BUS. CORP. LAW §§ 1315-20 (McKinney 1986). These statutes are discussed *supra* text accompanying notes 63-66.

⁸⁷ *E.g.*, *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984) (applying a New York statute to a Panamanian corporation on the issue of parent/subsidiary voting rights); *Tankersley v. Albright*, 374 F. Supp. 538 (N.D. Ill. 1974), *aff'd in part, rev'd in part*, 514 F.2d 956 (7th Cir. 1975) (applying Illinois law to voting trust of Delaware corporation); *Wilson v. Louisiana-Pacific Resources, Inc.*, 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982) (applying California cumulative voting law to a Utah corporation); *Western Air Lines, Inc. v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961) (applying California cumulative voting law to a foreign corporation); *Gries Sports Enterprises, Inc. v. Modell*, 15 Ohio St. 3d 284, 473 N.E.2d 807 (1984), *cert. denied*, 473 U.S. 906 (1985) (applying Ohio law to a voting agreement made by the shareholders of a Delaware corporation). The *Wilson* case contains a fairly sophisticated discussion of the constitutional issues.

the internal affairs rule is not rigorously adhered to. Corporations have already been opened up to the uncertainty of modern choice-of-law interest analysis, and the heralded catastrophe has not materialized.

There is, in addition, a second and more critical point. If the *German American Coffee* line of cases merely presented the problem of so-called "pseudo-foreign" corporations—corporations whose foreignness consisted exclusively in the naked fact of out-of-state incorporation—then these cases would constitute no more than a fairly manageable, perhaps uncontroversial exception to the internal affairs rule. They would not fundamentally challenge the rule itself. After all, even the *Restatement* permits departure from the internal affairs rule where a foreign corporation has virtually no real contacts with its incorporating state.⁸⁸

The problem of "pseudo-foreign" corporations, however, is in reality a limiting case of a much deeper and more pervasive difficulty in the internal affairs doctrine. The concept of "internal" affairs requires a parallel, opposing concept of externality; clearly no one is prepared to preclude a state in which a foreign corporation does business from applying its own law when the corporation has contractual or tortious dealings with that state's citizens. The internal affairs doctrine is necessarily inapplicable when interests external to the corporation are implicated. As the Supreme Court itself has stated: "As a general matter, the law of the state of incorporation normally determines issues relating to the *internal* affairs of a corporation. . . . Different conflicts principles apply, however, where the rights of third parties *external* to the corporation are at issue."⁸⁹

This formulation, meant simply to set forth the internal affairs doctrine, in fact undermines the doctrine's very foundation. The most "internal" of corporate affairs, as we have seen, can affect third-party rights. There can be no bright line—indeed no line at all—drawn to separate internal and external affairs; a corporation's internal affairs *are* external affairs when they implicate third-party rights.

Case law bears out this fundamental incoherence in the internal affairs doctrine. When third parties, typically creditors who are residents of the forum state, sue a foreign corporation or its members, courts have not hesitated to find that seemingly internal matters are in this context external affairs subject to the forum state's law.⁹⁰ For example, in a case

⁸⁸ See RESTATEMENT, *supra* note 2, § 302 comment g.

⁸⁹ *First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983) (original emphasis).

⁹⁰ See, e.g., *Pink v. AAA Highway Express, Inc.*, 314 U.S. 201 (1941) (forum state may apply its law to the question of whether defendant was technically a stockholder of the corporation); *Thomas v. Matthiessen*, 232 U.S. 221 (1914) (forum state may apply its law to the issue of shareholder liability where the shareholder consented to the corporation's doing business in that state); *Loveridge v. Dreagoux*, 678 F.2d 870, 878 (10th Cir. 1982) (forum

where liability turned on the question of whether the foreign corporation had been validly incorporated, the Tenth Circuit held as follows:

We are not unaware of the rule that the internal affairs of the corporation, such as the relationship of the officers and directors to the corporation, are governed by the state of incorporation. In this case the validity of the corporation arises in the context of fraud and misrepresentations to third parties. Thus, it was not an internal matter.⁹¹

In reality then, the internal affairs doctrine can provide no certainty whatsoever: the applicability of the doctrine may be determined by the "context" in which it is raised, and the interests of third parties can supply courts with a perfectly principled basis on which to disregard the law of the incorporating state in favor of a local law more sympathetic to the forum state's interests. At the same time, it is easy to find cases adhering to the internal affairs doctrine even though third-party interests were clearly affected thereby.⁹²

A radical open-endedness is thus inherent in the internal affairs doctrine and cannot be avoided so long as "internal" affairs are defined as distinct from matters affecting third-party rights. And this distinction is itself inescapable in order for states to be able to protect their own residents in dealings with foreign corporations—a limitation on the internal affairs doctrine that has always been regarded as indispensable. Of course, despite its open-endedness, the internal affairs rule may be perfectly justifiable as a tool of choice-of-law jurisprudence, which has to a large extent embraced a case-by-case, context-specific analysis. For *constitutional* purposes, however, where the entire argument in favor of the internal affairs rule rests on the supposed certainty, uniformity and

state may apply its law to the issue of whether a corporation had been validly incorporated); *In re Acushnet River & New Bedford Harbor Proceedings*, 675 F. Supp. 22, 31 (D. Mass. 1987) (stating that the internal affairs rule did not apply to the issue of shareholder liability where "the rights of third parties" were involved); *Edwards v. Schillinger*, 91 N.E. 1048, 1051 (Ill. 1910) (holding that the term "internal affairs" did not embrace matters affecting creditors' rights); *Cleaton v. Emery*, 49 Mo. App. 345 (1892) (applying forum state's law to issue of incorporator's liability).

⁹¹ *Loveridge v. Dreagoux*, 678 F.2d 870, 878 (10th Cir. 1982) (citation omitted).

⁹² *See, e.g.*, *Robert A. Wachsler, Inc. v. Florafax Int'l, Inc.*, 778 F.2d 547, 550 (10th Cir. 1985) (applying doctrine to the issue of voidability of a contract made by the corporation with a third party); *McDermott Inc. v. Lewis*, 531 A.2d 206, 215 (Del. 1987) (applying doctrine to determine voting rights of foreign corporation's subsidiary, thereby affecting the rights of the subsidiary's shareholders); *Zion v. Kurtz*, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980) (applying doctrine to shareholders' agreement and annulling certain business contracts made by the corporation because they violated the shareholders' agreement).

predictability to which the rule is claimed to give rise, the situation is plainly quite different.

Constitutionalizing the internal affairs doctrine would not produce the absolute choice-of-law certainty and predictability that is generally supposed. Difficult choice-of-law problems would still arise; the only difference is that they would take the form of attempts to distinguish "internal" from "external" affairs. Instead of producing ease and predictability, the doctrine will devolve into a case-by-case analysis measuring the "external" effects of putative "internal" conduct and then, inevitably, balancing those effects against the need for choice-of-law certainty.

The inevitability of this development is particularly foreseeable with respect to state regulation of tender offers. A change in control of a corporation is not easily categorized as an "internal" or an "external" event. Justice White tried to answer this question definitively in *MITE*, stating that "[t]ender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company."⁹³ On the other hand, ordinary mergers may equally "contemplate transfers of stock by stockholders to a third party," yet mergers have always been understood to be within the incorporating state's legislative province.⁹⁴ In fact, a great number of the myriad defenses to hostile takeover attempts that states might want to regulate—shareholder rights plans ("poison pills"), greenmail, restructurings, the issuance of preferred stock with various covenants or voting provisions, control shares procedures, and so on—could all be characterized as matters of purely "internal" corporate governance.

State takeover law is, moreover, rapidly evolving. The control shares statute is not the only form of takeover regulation currently in use; several states are experimenting with "business combination statutes" that give the incumbent directors enormous power in deciding whether to approve a proposed acquisition. Unless the directors approve the takeover offer before the acquisition of shares is consummated, the acquiror cannot for a period of several years combine in any way with the target company (which is usually considered necessary for the acquiror to reap its anticipated profit).⁹⁵ The "internal" or "external" nature of this form of takeover regulation will invariably be a subject of vigorous debate. Yet it is difficult to see how the question can even be meaningfully approached. The truth is that corporate control contests are simultaneously both "internal" and "external" corporate affairs; they go to the heart of corporate governance but also implicate important rights and interests of third parties—those of the acquirors as well as those of local business or

⁹³ *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

⁹⁴ The *CTS* Court made this point as a fairly explicit rebuttal to the *MITE* analysis. See *CTS Corp. v. Dynamics Corp. of Am.*, 106 S. Ct. 1637, 1649 (1987).

⁹⁵ See, e.g., N.Y. BUS. CORP. LAW § 912 (McKinney 1986).

employee communities. For this reason, the internal affairs doctrine cannot coherently provide choice-of-law stability in this field.

In fact, it seems quite clear that the terms "internal" and "external" must end up as purely conclusory labels should the internal affairs rule be constitutionalized. So long as a matter ceases to be purely "internal" to a corporation when the regulating state can claim that its interests may be seriously injured by the transaction in question, then the internal/external analysis will be nothing more than standard choice-of-law interest analysis under a different name. The internal affairs doctrine will not solve the choice-of-law difficulties; it can only mask those difficulties under a formalistic effort to distinguish between "internal" and "external" matters.

V. CONCLUSION

Today there is once again an increasing "Delawarization" of this country's corporations.⁹⁶ To constitutionalize the internal affairs doctrine would, as Professor Buxbaum has observed, create a corresponding "Delawarization" of the entire country's corporations law.⁹⁷ For the sake of a simplicity or certainty, the need and prospects for which appear to be greatly exaggerated, such a holding would sacrifice the value of diversity and experimentation among state corporation codes (in particular among legislative responses in the takeover context) as well as the legitimate interests of those states that are the true business "homes" of certain corporations but that would be constitutionally disabled from protecting their interests.

It is perhaps a flaw in federal law (constitutional and statutory) that it provides no choice-of-law rules as between the laws of states that have significant contacts to a given subject matter. But that deficiency exists, and in virtually every area of law today, "interest analysis" is the accepted means of resolving choice-of-law questions. The day is past when conflicts law and, indeed, Full Faith and Credit law employed tests looking mechanically to the "jurisdiction where a particular event occurred."⁹⁸ To hold that the Commerce Clause requires courts mechanically to enforce the internal affairs doctrine would be to adopt a course that has already been tried and rejected: "a choice-of-law analysis which, for all intents and purposes, gave an isolated event—[the chartering of the corporation in a particular state]—controlling constitutional signif-

⁹⁶ See Buxbaum, *supra* note 12, at 33 & n.20.

⁹⁷ See *id.* at 35.

⁹⁸ *Allstate Insurance Co. v. Hague*, 449 U.S. 302, 308 n.11 (1981) (plurality opinion); see also *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985) (adopting the *Allstate* plurality analysis); *supra* note 12.

icance, even though there might have been contacts with another state” that justify application of its law instead.⁹⁹

It seems highly unwarranted to single out corporations law as the only area in which ordinary choice-of-law rules, policies of comity, and the enforcement by each state of other state’s prior adjudications cannot be expected adequately to deal with a problem encountered in every aspect of a multi-sovereign system.¹⁰⁰ There is no empirical evidence supporting the view that these mechanisms are inadequate in this context, and there seems small doctrinal justification for constitutionalizing this particular fraction of the commercial choice-of-law field.

At the most, one might suggest a Commerce Clause rule that only the state of incorporation or a state with such substantial contacts that it may claim to be the corporation’s business domicile (as defined by high percentages of assets, revenues, employees, etc.) may regulate the corporation’s “internal” affairs self-governance. In addition, a significant resident shareholder percentage might also be required. This test would not purport to create perfect choice-of-law certainty. Conflicts might still arise—primarily between the incorporating state and the business domicile state but also occasionally between states able to satisfy a business domicile test—as in fact they have already. The point, however, would be to minimize the potential number of states that might legitimately claim to regulate a given corporation’s “internal” affairs without engraving in stone the unwarranted, impolitic, and ultimately unsuccessful rigidities of the internal affairs doctrine.

⁹⁹ *Allstate*, 449 U.S. at 308 n.11 (plurality opinion).

¹⁰⁰ See Buxbaum, *supra* note 12, at 45-52.

