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The Law Applicable to a Derivative Action on Behalf of a Foreign Corporation - Corporate Law in Conflict

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The Law Applicable to a Derivative Action on Behalf of a Foreign Corporation—Corporate Law in Conflict

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In corporate law, the derivative action mechanism allows minority shareholders and, in certain jurisdictions, single directors or even creditors to file and litigate on behalf of the corporation a lawsuit against an insider or a third party whose action has allegedly injured the corporation. The derivative action is a mechanism that corporate law furnishes to tackle agency problems because the corporate insiders who should initiate such claims occasionally become caught in a conflict of interests. Obviously, each jurisdiction decides whether to employ a derivative action mechanism and on what terms. However, in a globalized world that offers many attractive places in which investors can incorporate their businesses, corporate law regulation has become increasingly affected by surrounding regulatory environments. In many respects, conflict-of-laws rules manage the interaction between local and foreign regulatory rules. The purpose of this Article is to discuss the regulation of derivative actions when this mechanism is evoked in the context of a foreign corporation. This rather common scenario creates a choice-of-law question: should the terms and conditions for filing a derivative action on behalf of a foreign corporation (as opposed to the cause-of-action itself) be regulated by the law of the forum or by the law of the place of incorporation? For example, should the forum court enable plaintiffs to rely on the forum's local derivative action mechanism when the foreign law of the place of incorporation rules out completely the possibility of derivative actions being filed? This Article analyzes the doctrinal contexts that may serve as a legal platform for resolving this question, as well as the relevant considerations to be taken into account. The Article subsequently argues that, in contrast to a prevailing perception, the law of incorporation should not always be applied. It is further argued that the public policy doctrine, rather than any other doctrinal context, is best suited to serve as a platform for adjudicating the choice-of-law question and that forum shopping concerns should be excluded from this question and confined to the context of jurisdiction ascertainment.

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Introduction

In a globalized world that offers many attractive places where investors can incorporate their businesses, corporate law regulation becomes increasingly affected by conflict-of-laws (private international law) rules. Indeed, a closely kept secret among conflict of laws scholars concerns the understanding that substantive laws—such as jurisdictions' corporate codes—are only as relevant to a particular corporation and its stakeholders[1] as conflict-of-laws doctrines indicate. Neither the most explicit contractual agreement nor a specific preemptory statute of the highest order can overcome the power of a choice-of-law rule that directs the court to apply a different norm to a specific dispute.[2] In this sense, corporate codes

1. Corporate stakeholders include not only shareholders (or holders of an entitlement to the corporate entity's equity), but also any other person with an interest in the corporate entity and its operations, including but not limited to creditors, employees, suppliers, lenders, customers, and even the general public. Scholars and lawmakers have argued for some time over whether a corporate entity should be managed for the benefit of its shareholders only, or for the benefit of other stakeholders as well. *See, e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 311-12 (2d ed., 2009) (describing the debate); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189-90 (2002) (describing the same debate). For current purposes, however, this controversy need not be resolved and is omitted from the discussion.

2. In the conflict-of-laws world, a specific dispute is what the atom is in the physical world. In other words, it is the basic unit of "matter" to which all judicial action relates, such as characterization and application of a particular law. Note, however, that in several contexts of characterization, such as the context of the substance-procedure distinction that is discussed below, the process of characterization often targets a norm or a rule of law rather than a specific dispute or a set of facts. *See* George Panagopoulos, *Substance and Procedure in Private International Law*, 1 J. PRIVATE INT'L L. 69, 73-75

and case law can only articulate norms that possess relative application and force.

One context that demonstrates the importance of understanding the interaction between corporate law and conflict-of-laws concerns the application of the forum's derivative action mechanism when such a suit is filed on behalf of a *foreign* corporation.[3] This context should be of interest to both local lawyers representing foreign corporations and to local investors who invest in, or consider investing in, foreign corporations.[4]

In corporate law, a derivative action mechanism allows minority shareholders and, in certain jurisdictions, single directors or even creditors[5] to file and litigate a lawsuit on behalf of the corporate entity against an insider (e.g., a presiding or former director, officer, or controlling shareholder) or a third party whose action has allegedly injured the corporate entity.[6] The derivative action is an essential and well-known corporate gov-

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(2005). When a court characterizes a specific dispute, rather than a norm, it demonstrates a partisan approach because an announcement of a procedural characterization will lead the court to immediately apply its own law while disregarding the contents of the foreign law. *See id.* at 70. However, characterizing a norm, rather than a specific dispute, demonstrates a multi-sided approach because a court will not ignore the foreign law unless its norm is announced as "procedural." Moreover, note that another problem concerns the question of what should be characterized—a single rule or a "package" of rules. *See* Janeen M. Carruthers, *Damages in the Conflict of Laws–The Substance and Procedure Spectrum:* Harding v. Wealands, 1 J. PRIVATE INT'L L. 323, 327 (2005) (discussing the problem as it manifests in *Harding v. Wealands* and advocating an "unpacking" approach).

3. Thus, this Article does not address questions of jurisdiction but only of choice-of-law.

4. For U.S. lawyers and legal scholars, this Article offers a comparative perspective by envisioning the "traditional" conflict-of-laws legal framework of non-U.S. common law and European jurisdictions. However, for readers interested in a normative analysis of U.S. law, the Article makes note, whenever relevant, of the different choice-of-law methodology employed by many U.S. states. *See, e.g., infra* note 16 (making note of different rules between jurisdictions). Consider the difference between the "traditional" choice-of-law methodology, which prevails in Europe and in many common-law jurisdictions, such as the United Kingdom, Canada, and Australia, and the "modern" choice-of-law methodology, which many U.S. states have widely adopted. In short (and being highly simplistic), the "traditional" choice-of-law methodology relies on a neutral process of choice-of-law, which starts with characterization (e.g., torts), moves on to finding the related connecting factor (e.g., place of the wrong), and later localizes it to derive the applicable law (deciding that jurisdiction X was the location of the wrong and thus its laws should apply). In this rather mechanical process, policy considerations cannot be employed in the face of the concrete litigated case and are restricted to the ex-ante formulation of a connecting factor. In contrast, the "modern" choice-of-law methodology (such as the theories of the Most Significant Relationship or Governmental Interest Analysis) relies on a more open judicial pursuit of various policy considerations. For a thorough discussion and analysis of the differences between the two methodologies, see generally DAVID P. CURRIE ET AL., CONFLICT OF LAWS: CASES-COMMENTS-QUESTIONS (8th ed., 2010); SYMEON C. SYMEONIDES, THE AMERICAN CHOICE-OF-LAW REVOLUTION: PAST, PRESENT AND FUTURE (2006).

5. *See, e.g.*, ARAD REISBERG, DERIVATIVE ACTIONS AND CORPORATE GOVERNANCE: THEORY AND OPERATION 204-06 (2007) (mentioning Canada and Israel as examples).

6. *See generally* A. J. BOYLE, MINORITY SHAREHOLDERS' REMEDIES (2002); DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE 1-3 (2011). Note the following: First, the derivative action is a representative action, i.e., it is a claim filed by

ernance device,[7] the purpose of which is to ensure that agency problems that inherently trouble corporations do not hamper attempts to obtain redress from wrongdoers whose actions have injured the corporation.[8]

However, the question is whether disputes concerning the terms and conditions for filing a derivative action on behalf of a foreign corporation (as opposed to the question of whether a cause-of-action exists)[9] should be regulated by the law of the forum (in conflict-of-laws jargon: *lex fori*) or by the law of a foreign jurisdiction.[10] Usually the possible alternatives from which each jurisdiction chooses are either (1) the law of the foreign jurisdiction in which the relevant corporate entity has incorporated (called *lex incorporationis*), or (2) the law of the jurisdiction in which the corporate entity has its principal place of business (called the law of the real seat).[11]

A on behalf of B. Second, while a class action is also a representative action, the derivative suit asserts a claim of injury suffered by the corporate entity itself, while the class action asserts a claim of injury suffered by the shareholders in person. However, drawing a line between these two kinds of claims is not always easy and may require a somewhat arbitrary decision. Third, while of course varying from one jurisdiction to another, the terms for filing a derivative action usually differ from those necessary to filing an ordinary civil action. To be sure, because the derivative action is a representative action, lawmakers usually include certain safeguards to ensure that those represented are not deprived. For example, in many jurisdictions court approval is required before a derivative action is allowed to proceed. *See, e.g.*, FED. R. CIV. P. 23.1 (U.S.); Civil Procedure (Amendment) Rules 2000 S.I. 221 (L.1.) § 19.9(3) (Eng. & Wales); *see also* Companies Act, c. 46 2006, § 261 (U.K.).

7. *See* Harald Baum & Dan W. Puchniak, *The Derivative Action: An Economic, Historical and Practice-Oriented Approach*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 1-2 (Dan W. Puchniak et al. eds., 2012) (describing the derivative action as a "global phenomenon").

8. *See* REISBERG, *supra* note 5, at 1-2, 18-19, 20-24. For a formal model of the agency problem, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 313-19, 331-32 (1976). Basically, an agency problem is created whenever A, who has some control over B's property, also has an interest different than B's but is better informed than B regarding the use of the property.

9. Indeed, most jurisdictions adhere to a choice-of-law rule applying the law of the state of incorporation or the law of the real seat of the corporation, thereby allowing foreign law to regulate the existence of a cause-of-action. *See, e.g.*, Konamaneni v. Rolls Royce Indus. Power (India) Ltd., [2001] EWHC (Ch) 979, [31], [34], [37], [42]-[48] (Eng. & Wales); *see also* DEMOTT, *supra* note 6, at 212 (discussing the law in various U.S. states).

10. This is, of course, a choice-of-law question that should be discerned from a possible choice-of-forum query. For example, in recent years U.S. corporations have begun to adopt choice-of-forum clauses in their governance documents that require plaintiffs whose lawsuits are either derivative or concern the internal affairs of the corporation to initiate the litigation in a particular forum. *See* DEMOTT, *supra* note 6, at 37-40 (discussing relevant cases and possible limitations on the adoption of such provisions). However, forum selection provisions do not preclude the need to resolve the choice-of-law question discussed in this Article. To the extent that courts enforce such provisions, the immediate result will be the resolution of the choice-of-law question in accordance with the conflict-of-laws doctrines that prevail at the agreed-upon forum.

11. *See* JUSTIN BORG-BARTHET, THE GOVERNING LAW OF COMPANIES IN EU LAW 4-8 (2012) (discussing the theoretical controversy between the two approaches and its history); PASCHALIS PASCHALIDIS, FREEDOM OF ESTABLISHMENT AND PRIVATE INTERNATIONAL LAW FOR CORPORATIONS ch. 1 (James J. Fawcett ed., 2012) (discussing and comparing the two choice-of-law rules); STEPHAN RAMMELOO, CORPORATIONS IN PRIVATE INTERNATIONAL LAW:

For example, should courts enable plaintiffs to rely on the forum's local derivative action mechanism when the corporate entity in question is incorporated under a foreign law that completely rules out the possibility of derivative actions being filed?[12] Other examples of this choice-of-law question are abundant because different jurisdictions have different prerequisites for launching a derivative action.[13]

A EUROPEAN PERSPECTIVE 11-20 (2001) (discussing the differences between the two alternative approaches); Werner F. Ebke, *The "Real Seat" Doctrine in the Conflict of Corporate Laws*, 36 INT'L L. 1015, 1015-16 (2002) (explaining the theoretical foundations of the "real seat" doctrine); Christian Kersting, *Corporate Choice of Law: A Comparison of the United States and European Systems and a Proposal for a European Directive*, 28 BROOK. J. INT'L. L. 1, 1-2 (2002) (comparing the United States and the European Union); Symeon C. Symeonides, *Choice of Law in the American Courts in 2004: Eighteenth Annual Survey*, 52 AM. J. COMP. L. 919, 989 (2004) (describing the *lex incorporationis* approach in the United States). In those cases in which the corporation's principal place of business is the forum state itself, a possible conflict-of-laws question would emerge only if the forum is one that adheres to a *lex incorporationis* approach.

12. *See, e.g.*, Batchelder v. Kawamoto, 147 F.3d 915, 916-17, 921 (9th Cir. 1998), *cert. denied*, 119 S. Ct. 446 (involving a derivative action filed in the United States by an American holder of American Depository Receipts—receipts representing ownership of equity shares in a foreign company issued against ordinary shares held in custody by a third party—representing ownership rights in a Japanese corporation); City of Harper Woods Emps.' Ret. Sys. v. Olver, 577 F. Supp. 2d 124 (D.D.C. 2008) (involving a derivative action filed in the United States by an American holder of American Depository Receipts issued in relation to a U.K. corporation headquartered in London); *In re* Tyco Int'l, Ltd., 340 F. Supp. 2d 94, 95-96, 98, 102 (D.N.H. 2004) (involving a derivative action filed in the United States by an American shareholder on behalf of a company reincorporated in Bermuda); Wilson v. ImageSat Int'l N.V., No. 07 C 6176, 2008 U.S. Dist. LEXIS 57897, at *13-16 (S.D.N.Y. July 22, 2008) (involving a derivative action filed in Israel by Israeli minority shareholders of a company incorporated in the Dutch Antilles for tax purposes against the company's controlling shareholders and officers, all of whom were also residents of Israel. The complaint against the defendants focused on allegations of misconduct by the defendants that inflicted serious economic damage on the company).

13. Thus, other specific disputes that may be the subject of a choice-of-law inquiry in the context of the derivative action mechanism include, but are not limited to, the following factors. First, the nature of the requirement that the plaintiff maintain continuous ownership of the corporate entity's shares throughout the litigation of the derivative action. Second, the plaintiff's entitlement to file a *double* derivative action—an action on behalf of a subsidiary corporation—rather than on behalf of the corporation itself. *See* DEMOTT, *supra* note 6, at 209-10, 215 (discussing relevant cases displaying interstate and inter-country conflict-of-laws questions). Third, the nature and terms of the demand requirement, i.e., the requirement that the plaintiff prove that the corporate entity's directors wrongfully rejected her demand to act themselves in order to obtain redress on behalf of the corporate entity. *See, e.g.*, Lewis v. Dicker, 459 N.Y.S.2d 215 (N.Y. Sup. Ct. 1982). Fourth, the nature and terms of the contemporaneous ownership requirement, i.e., the required proof from the plaintiff of ownership of the corporate entity's shares at the time of the wrong. *See, e.g.*, Pessin v. Chris-Craft Indus., Inc., 586 N.Y.S.2d 584, 586 (N.Y. App. Div. 1992); Zhong Zhang, *The Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement is Actually for Nothing*, 28 UCLA PAC. BASIN L.J. 174, 177 (2011) (describing a 1% minimum shareholding requirement under Chinese law). Fifth, the questions of litigation costs and attorneys' fees and who should bear these costs. Sixth, the requirement that the plaintiff post some kind of collateral as a condition for filing a derivative suit. *See* Ann M. Scarlett, *Investors Beware: Assessing Shareholder Derivative Litigation in India and China*, 33 U. PA. J. INT'L L. 173, 184, 207-08 (2012) (discussing different derivative action mechanisms in the United States, India, and China). Seventh, the terms of a "good faith" requirement,

Moreover, how should the forum court approach this question? According to the conflict-of-laws doctrine of many jurisdictions in the United States and worldwide, when investors decide to incorporate abroad they subject themselves either to the law of the state of incorporation[14] or to the law of the corporation's real seat,[15] depending on each jurisdiction's pre-ordained choice-of-law rule.[16] Henceforth, for reasons of convenience only, both shall be referred to as *lex incorporationis*. Notwithstanding the exact choice-of-law methodology to which the relevant forum adheres, the foreign *lex incorporationis* usually regulates all matters and relationships—to be accurate, all specific disputes litigated ex-post before the forum—that are characterized as the "internal affairs" of the corporate entity.[17] Such affairs include "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders . . . ."[18] For example, the law of the state of incorporation will regulate specific disputes concerning voting,[19] capital rights, corporate governance, and

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focusing on the plaintiff's behavior and motivation to sue. *See, e.g.*, Jennifer Payne, *"Clean Hands" in Derivative Actions*, 61 CAMBRIDGE L.J. 76, 80-82 (2002). Eighth, the terms of a "best interests of the corporation" test, which examines whether a derivative action is in the best interests of the corporate entity or whether it is justified from a cost-benefit perspective. *See, e.g.*, Zhang, *supra*, at 185-86.

14. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 296-300, 303-310 (1971) (discussing the U.S. perspective); MODEL BUS. CORP. ACT § 15.05(c) ("This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.").

15. *See, e.g.*, RAMMELOO, *supra* note 11, at 10 (describing the European perspective). The law of the real seat is usually defined as referring to the place where the central management decisions are implemented on a day-to-day basis. *See* Ebke, *supra* note 11, at 1016.

16. The discussion will proceed based on the assumption that the forum jurisdiction applies *lex incorporationis* to specific disputes characterized as "internal affairs of the corporation." Of course, if the forum applies instead the law of the corporate entity's "real seat" to such disputes, the discussion in this Article should be amended accordingly, although the analysis and the normative arguments it puts forward are not expected to change much. Indeed, the Article discusses foreign corporate entities. In jurisdictions that apply the law of the real seat to the internal affairs of the corporate entity, a choice-of-law question usually arises only when the corporate entity's real seat is foreign. If the corporate entity's real seat is in the forum jurisdiction, there seems to be no problem associated with applying the law of the forum from the beginning. Similarly, even if the corporate entity has incorporated in foreign jurisdiction A and has its real seat in foreign jurisdiction B, the conflict-of-laws upon which the current Article focuses is, once again, between the law of the forum and one of these foreign laws (either A's or B's). *See generally* RAMMELOO, *supra* note 11, at 174-236 (listing European jurisdictions that apply the law of the corporate entity's "real seat").

17. *See, e.g.*, DEMOTT, *supra* note 6, at 207-29; Symeonides, *supra* note 11, at 989. One should keep in mind, however, that legislators can codify the application of this foreign law to other matters, as well. *See infra* Part I.D.

18. Edgar v. MITE Corp., 457 U.S. 624, 645 (1982); *see also* PASCHALIDIS, *supra* note 11, at 4 (providing a list of specific disputes which are treated in the United Kingdom as issues of "internal affairs of the corporation").

19. *See, e.g.*, McDermott Inc. v. Lewis, 531 A.2d 206, 209 (Del. 1987) (applying the law of Panama, where the corporation is incorporated, to a dispute over voting with its shares)

breach of fiduciary duties[20] (even the existence of a cause-of-action upon which a derivative suit may be filed), even if the dispute is litigated before the forum.[21] However, questions that pertain to the derivative action mechanism itself may be treated differently, particularly in non-U.S. jurisdictions following the traditional choice-of-law methodology.

One way to frame the question—assuming that the forum does *not* employ the straightforward U.S. methodology of applying the law with the most significant relationship to the occurrence, transactions, and parties[22]—would be to contemplate whether the appropriate characterization of the specific dispute regarding the applicability of the forum's derivative action mechanism (or regarding the availability of the mechanism itself) is procedural, rather than substantive.[23] The resulting characterization choice is necessary for the purpose of deciding whether foreign law should regulate the derivative action mechanism even if the lawsuit is litigated in the forum court (i.e., if the mechanism is characterized as substantive), or regulated by the forum law itself (if characterized as procedural).[24]

Alternatively, the availability of the forum's local derivative action mechanism when the corporation is foreign can be dealt with not as an "internal affairs" issue or as a substance-versus-procedure issue, but rather as a question of public policy.[25] In a typical scenario, a litigant would argue that applying the foreign derivative action law (as *lex incorporationis*) is inconsistent with the forum's public policy doctrine. The public policy doctrine (*ordre public international*) prevents the application of foreign law (or judgment) inasmuch as its application is inconsistent with the forum's "public policy,"[26] i.e., with "some fundamental principle of justice, some

20. *See, e.g.*, Tyco Int'l Ltd. v. Walsh, 751 F. Supp. 2d 606, 619 (S.D.N.Y. 2010) (applying the law of Bermuda, where the corporation is incorporated, to a claim for breach of fiduciary duty).

21. Of course, specific disputes that are not characterized as "internal affairs" of the corporate entity shall be regulated by a different law according to the forum's other choice-of-law rules. For example, if the litigated specific dispute concerns the interpretation of a contract executed between the corporate entity and a third party (for instance, one of its vendors), that contract would be interpreted under the auspices of the applicable law according to the forum's choice-of-law rule regarding contract interpretation.

22. For a detailed discussion of this modern, U.S.-oriented choice-of-law approach, see CURRIE ET AL., *supra* note 4, at 200-24; SYMEONIDES, *supra* note 4, at 63-72.

23. *See infra* Part I.B.

24. For a discussion of the substance-procedure distinction and its related choice-of-law rule, see ADRIAN BRIGGS, THE CONFLICT OF LAWS 33-36 (2002); LAWRENCE COLLINS ET AL., 1 DICEY, MORRIS AND COLLINS ON THE CONFLICT OF LAWS ch. 7 (14th ed., 2006); CURRIE ET AL., *supra* note 4, at 48-61; RICHARD GARNETT, SUBSTANCE AND PROCEDURE IN PRIVATE INTERNATIONAL LAW ¶ 2.17 (2012). Of course, the characterization of this dispute is a matter to be unilaterally decided by each jurisdiction according to its choice-of-law rules.

25. *See infra* Part I.B.

26. *See, e.g.*, Kuwait Airways Corp. v. Iraqi Airways Co. (Nos. 4 and 5) [2002] UKHL 19, 2 AC 883 (H.L.) 972 (appeal taken from Eng.); Vervaeke v. Smith, [1983] 1 AC 145 (H.L.) 164 (appeal taken from Eng.); COLLINS, *supra* note 24, at 1626; *see also* M. Forde, *The "Ordre Public" Exception and the Adjudicative Jurisdiction Conventions*, 29 INT'L & COMP. L.Q. 259, 259-60 (1980) (discussing the various meanings and doctrines associated with public policy).

prevalent conception of good morals, some deep-rooted tradition of the common weal."[27] Although the doctrine is suspect as possibly generating uncertainty due to its flexible nature,[28] it is an escape hatch. Specifically, the doctrine allows the forum court to avoid applying a foreign law the outcome of which, in light of that law's contents, the court considers unwarranted.

Yet a third alternative for framing the choice-of-law question also exists. Rather than framing the issue as one of "internal affairs," of substance-versus-procedure, or of public policy, the question regarding the availability of the forum's local derivative action mechanism when the corporation is foreign can be dealt with as one of extraterritorial application of the forum derivative action statute.[29] Such an approach often focuses the discussion on the doctrinal context of the presumption against extraterritoriality. Courts employ this presumption, which serves as a tool of construction, to determine the applicability of local regulations to transnational cases, i.e., cases involving foreign elements.[30] Courts employ the presumption against extraterritoriality because the language of the statute does not typically disclose the legislature's intention with regard to the transnational context—should the local statute apply in an extraterritorial manner or not, i.e., should it apply to any specific transnational case?[31] A court determining if it should entertain a derivative action against a foreign corporation can use the presumption against extraterritoriality to interpret the forum's derivative suit statute to limit its application to local corporations, thereby excluding foreign incorporated entities.

The goal of this Article is to outline the methodological disposition of possible specific disputes concerning the derivative action mechanism

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27. Loucks v. Standard Oil Co. of N.Y., 120 N.E. 198, 202 (1918).

28. *See, e.g.*, Alex Mills, *The Dimensions of Public Policy in Private International Law*, 4 J. PRIVATE INT'L L. 201, 202-03 (2008).

29. *See infra* Part I.C.

30. *See, e.g.*, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2878 (2010) ("When a statute gives no clear indication of an extraterritorial application, it has none.").

31. *See, e.g.*, Daniel S. Kahn, *The Collapsing Jurisdictional Boundaries of the Antifraud Provisions of the U.S. Securities Laws: The Supreme Court and Congress Ready to Redress Forty Years of Ambiguity*, 6 N.Y.U. J. L. & BUS. 365, 371-81 (2010); Jeffrey A. Meyer, *Dual Illegality and Geoambiguous Law: A New Rule for Extraterritorial Application of U.S. Law*, 95 MINN. L. REV. 110, 114 (2010). One could either wonder why this anomaly persists or conclude that legislatures created it intentionally. *See* Brainerd Currie, *Married Women's Contracts: A Study in Conflict-of-Laws Method*, 25 U. CHI. L. REV. 227, 231-33 (1958) (describing how legislators fail to concern themselves with international applications of their laws). Of course, this is not always the case. In the United States, several states have "outreach statutes" that, in exceptional contexts, subject foreign corporations "doing business" at the forum to local regulation rather than to the *lex incorporationis*. Mostly, these exceptional contexts include disclosure of information about the corporation and service of process for the purpose of exercising jurisdiction over it. Occasionally, "outreach statutes" may be broader. For example, New York enacted a statute that explicitly applies local law to certain specific disputes that otherwise would be characterized as "internal affairs" of the corporate entity, such as liability of directors and officers. *See* DEMOTT, *supra* note 6, at 215-19; Kersting, *supra* note 11, at 25-36.

when a conflict of laws transpires in the broad sense. The emphasis on "the broad sense" refers to a possible regulatory clash, rather than to the technical choice-of-law question itself. Indeed, either the law of the forum or the law of the foreign jurisdiction under which the foreign corporation has incorporated typically regulates any case that raises the question of allowing a derivative action to proceed against a *foreign* corporation. Applying either regulation means rejecting the other.[32]

This Article introduces the possible conflict-of-laws doctrines that may serve, alternatively, as a platform for adjudicating and resolving the specific dispute concerning the appropriate derivative action mechanism. Three normative arguments are therefore put forward. First, the decision with regard to the choice of a derivative action mechanism is certainly not, as some might argue, one-dimensional. The argument specifically suggests refraining from across-the-board acceptance of the proposition that the choice of investors to incorporate abroad should unequivocally subject them to the application of the law of incorporation on all matters concerning intra-firm relations, including the nature and terms of the derivative action mechanism.

Second, from a choice-of-law methodology viewpoint, the public policy doctrine appears to be the better platform for resolving the dispute concerning the applicability of local derivative action mechanisms when such lawsuits are filed on behalf of foreign corporations. The public policy doctrine evolved as an exception in cases where foreign law is prima facie applicable and has recently been constrained along several limiting contours. Consequently, the public policy doctrine best fits the task.

Third, the Article explains why any possible problem of forum shopping should not influence the choice-of-law process. Instead, such problems should be solved with jurisdictional rules.

The remainder of the Article is organized as follows: Part I lays out the relevant conflict-of-laws doctrines. This part describes the broader context within which the relevant doctrines are evoked and sets the necessary background for the normative discussion in Part II. Part I also introduces the substance-procedure distinction, followed by a brief description of the well-known public policy doctrine and a short primer on extraterritoriality. Given this background, Part II deliberates on the question of choice-of-law with regard to the derivative action mechanism. The purpose, of course, is to decide which regulation the forum court should employ: local or foreign. Subsequently, Part II discusses the three aforementioned arguments. A conclusion follows.

32. *See, e.g.*, F. Hoffmann-La Roche Ltd. v. Empagran S.A., 542 U.S. 155, 165, 169 (2004) (noting that extraterritorial application of U.S. law is expected to interfere with other jurisdictions' attempts to regulate, particularly with respect to events that transpire in their own territories).

I. The Doctrinal Setting

A. A Note on Framing

In a private ordering scenario, a "clash" between regulations can translate into one of two adjudicative paths and correlated legal discussions, depending on the circumstances of each case. The first possible path leads the court to resolve a choice-of-law question. Sometimes the forum court is confronted with a question concerning the law applicable to a specific dispute litigated by the parties because each evokes a different law and argues for application of that law to solve the specific dispute. For example, the forum court may be called to decide which law applies to determine whether a particular condition is required, as a matter of law, to file a derivative action. A choice-of-law conflict would arise to the extent that the law of the forum and the law of the place of incorporation set different terms as a condition for filing a derivative action, and each litigant argues for the application of the law favorable to him.

The second possible path to adjudicating conflicting regulations originates in the context of extraterritoriality. Occasionally, rather than being asked to determine which of two possible laws—e.g., the law of the forum and a foreign law—is applicable to a specific dispute, the forum court may be called *only* to apply its own law, albeit in an "extraterritorial" manner. To illustrate with an example from a slightly different context: an American court may be called upon to apply § 10(b) of the Securities Exchange Act of 1934 to a case involving foreign parties and transactions.[33] Under such a setting, the question to be adjudicated becomes one of extraterritorial application of forum law without any of the parties arguing for application of a foreign law. In other words, the forum court in this last scenario is only asked to interpret a local statute to determine its applicability in an international context.

Note, however, that even when the court adjudicates the discussion as a question of extraterritoriality, there always exists an implied, and un-litigated, choice-of-law question. To begin with, there is the issue of the difference between the various laws concerned. Indeed, if the forum court is asked by a plaintiff to apply § 10(b) of the Securities Exchange Act of 1934 to a case involving foreign parties and transactions, it is only because the relevant foreign law, in the general sense,[34] is different from § 10(b) of the Securities Exchange Act of 1934 and does not offer the plaintiff as favorable a cause of action as the one offered by § 10(b). The defendant in such cases does not argue, of course, for the application of the foreign securities law—as the defendant does not seek to be liable at all—but instead she argues that § 10(b) of the Securities Exchange Act of 1934 does not apply to the case because it has no extraterritorial application. Fur-

33. *See, e.g.*, *In re* Nat'l Austl. Bank Sec. Litig., No. 03 Civ. 6537(BSJ), 2006 WL 3844463, at *1 (S.D.N.Y. Nov. 8, 2006) (the trial court's decision in the *Morrison* litigation).

34. This reservation is added to clarify that a difference in laws exists even if it derives from practical, rather than formal, issues; for example, foreign courts tend to award lower compensation in securities fraud cases than local courts.

thermore, if the forum court decides not to apply the local regulation (e.g., a U.S. court decides *not* to apply § 10(b) of the Securities Exchange Act of 1934 to a case involving Australian parties and transactions), then the direct consequence of such a ruling is to allow the relevant foreign law, rather than U.S. law, to regulate the situation. In other words, U.S. law withdraws to make room for the foreign regulation to apply. This consequence is the case even if no subsequent litigation, foreign or other, commences at all.

Thus, before turning to ascertain the law applicable to a derivative action filed on behalf of a foreign corporation, one needs to decide how to frame this question from the perspective of the forum's conflict-of laws doctrine. Obviously, when employing the modern, U.S.-oriented methodology—such as the approach that calls for applying the law with "the most significant relationship"—there is hardly any framing problem: the court conducts the relevant policy discussion while pursuing the law with the most significant relationship.[35] Moreover, when the parties bring the issue of extraterritoriality before the court, the court will probably frame the discussion as one concerned with the extraterritorial application of the law of the forum. However, when the parties' argument puts a traditional, rather than modern, choice-of-law question before the court because one of the parties evokes a foreign law, the discussion would probably occur in several other doctrinal settings.

Note in this last context that the focal point of a choice-of-law discussion, should one occur during the litigation, is not anticipated to be about application of the law of the state of incorporation (*lex incorporationis*). Indeed, the parties can easily be expected to invoke several conflict-of-laws doctrines that override the application of *lex incorporationis*. At least two doctrinal contexts can serve to frame the question of applicable law. These doctrinal contexts are mutually exclusive, and, moreover, other than arguments by the parties that require the court's decision, it is hard to point to any criteria according to which the court can be referred to one of these contexts rather than to the other. One context is the substance-procedure distinction; the second is the doctrine of public policy.

One could argue that the parties' adversary arguments will "decide" the doctrinal context in which the court will be required to contemplate the question of which law regulates the filing of a derivative action, whether local or foreign. Thus, instead of attempting to resolve the framing issue, the argument would hold that one should simply anticipate the possible doctrinal contexts and be prepared for each. However, as will be shown in Part II, the question of framing does have significance.

Nonetheless, before turning to a solution to the framing problem of deciding which law should regulate the disposition of a derivative action on behalf of a foreign corporation, the reader should first acquaint herself with the three possible doctrinal contexts that may serve as a platform for

35. *See, e.g.*, Larry Kramer, *Choice of Law in Complex Litigation*, 71 N.Y.U. L. REV 547, 555-56 (1996).

seeking the relevant answers. These doctrinal contexts include the substance-procedure distinction, the doctrine of public policy, and the doctrine of extraterritoriality.

B. The Substance-Procedure Distinction

1. The Doctrine

One of the most important and intriguing conflict-of-laws doctrines is the substance-procedure distinction. Being the law of the land worldwide,[36] the doctrine directs the forum to refrain from applying foreign norms characterized as procedural, even when the foreign law from which they originate should be the law applicable to the dispute. Instead, the forum is called upon to apply its own law.[37] Employing the doctrine can be fairly easy, as long as the issue of characterization is resolved and the court can announce the correct characterization. Herein lies the problem, because making the distinction between substance and procedure is a complex endeavor,[38] even when it is understood that the court makes its announcement only within the particular legal context of the choice-of-law process.[39] As in many other characterization settings, parties to the adver-

36. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS, § 122 (1971); Tolofson v. Jensen [1994] 3 S.C.R. 1022 (Can.), http://www.canlii.org/en/ca/scc/doc/1994/1994canlii44/1994canlii44.pdf; John Pfeiffer Pty Ltd. v Rogerson (2000), 203 CLR 503 (Austl.), *available at* http://www.austlii.edu.au/au/cases/cth/high_ct/2000/36.html; COLLINS, *supra* note 24, at 177. One should note, however, that in civil law systems, "procedure" is usually reserved to characterizing only issues pertaining to the actual process the court follows. *See* Martin Illmer, *Neutrality Matters–Some Thoughts About the Rome Regulations and the So-Called Dichotomy of Substance and Procedure in European Private International Law*, 28 CIV. JUST. Q. 237, 238 (2009). A different model may also exist. For example, China has recently enacted a new conflict-of-laws statute which does not explicitly prescribe the substance-procedure distinction (with one exception that concerns limitations). *See* Guangjian Tu, *China's New Conflicts Code: General Issues and Selected Topics*, 59 AM. J. COMP. L. 563, 571 (2011).

37. Phrased in this manner, the doctrine could be exposed as "escape hatch" in nature, allowing courts to avoid the application of foreign law even when such application is mandated prima facie. *See* CURRIE ET AL., *supra* note 4, at 39, 48-59 (describing the substance-procedure distinction as one of several "escape devices"); Adrian Briggs, *The Legal Significance of the Place of a Tort*, 2 OXFORD U. COMMONWEALTH L.J. 133, 136 (2002) (indicating the tendency of courts to manipulate the substance-procedure distinction in the absence of a formal legal exception to prevent the application of foreign law).

38. *See, e.g.*, Janeen M. Carruthers, *Substance and Procedure in the Conflict of Laws: A Continuing Debate in Relation to Damages*, 53 INT'L & COMP. L.Q. 691, 694 (2004); Anthony Gray, *Loss Distribution Issues in Multinational Tort Claims: Giving Substance to Substance*, 4 J. PRIVATE INT'L L. 279, 280-81 (2008); Panagopoulos, *supra* note 2, at 70-75. For an earlier observation see HERBERT F. GOODRICH, HANDBOOK ON THE CONFLICT OF LAWS 158-60 (1927).

39. The distinction between substance and procedure prevails in other legal contexts, as well. For example, under U.S. law, substance must be distinguished from procedure for the purposes of the Erie Doctrine, which mandates that federal courts exercising diversity jurisdiction must apply state substantive law and federal procedural law. *See* Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938). Retroactive effect is usually extended only to statutes, administrative regulations, or court rulings that are "procedural," rather than "substantive." *See, e.g.*, Tobias Barrington Wolff, *Federal Jurisdiction and Due Process in the Era of the Nationwide Class Action*, 156 U. PA. L. REV. 2035,

sarial proceeding will tend to argue zealously before the court for a characterization that best serves their own personal interest in the case, thus making the court's characterization announcement highly important. Occasionally, the court's characterization serves as the judicial decision that decides the entire case.

Two alternate problems undermine any effort to discover the correct characterization in the context of the substance-procedure distinction. Those who believe that characterizations should be neutral and can actually be derived *a priori*, as the traditional choice-of-law process mandates, face the problem of distinguishing "matter" or "right of action" (which mandate a characterization announcement of substance and application of the lex causae, which, in practice, would be a foreign law, of course) from "manner" or "remedy" (which mandate a characterization announcement of procedure and respective application of the forum law).[40] Alternatively, those who accept the notion that characterization can almost never be announced *a priori*[41] face the problem of deciding what should be the *rationale* driving the substance-procedure distinction and then, according to the rationale chosen, how to apply the rationale to the circumstances of the litigated case. The methodological approach adopted in this latter alternate context is simple: characterization should be employed in a functional manner, allowing the court to announce "substance" or "procedure" depending on the way in which a particular characterization would better comport with the rationale in question.[42]

2104-05 (2008). Of course, referring to a norm as substantive or procedural in one legal context certainly does not mandate an identical characterization in the context of conflict of laws. *See* Hanna v. Plumer, 380 U.S. 460, 471 (1965) ("The line between 'substance' and 'procedure' shifts as the legal context changes."); COLLINS ET AL., *supra* note 24, at 178; Walter Wheeler Cook, *"Substance" and "Procedure" in the Conflict of Laws*, 42 YALE L.J. 333, 345-46 (1933).

40. *See, e.g.*, Harding v. Wealands [2006] UKHL 32, [36]-[37], [83] (appeal taken from Eng.) (Lord Carswell); *id.* at [36]-[37] (Lord Hoffman); *see also* Gray, *supra* note 38, at 281-82 (discussing the context of a specific dispute regarding limitation periods).

41. *See, e.g.*, Cook, *supra* note 39, at 343 (noting that for the purpose of characterization, one should "admit that the 'substantive' shades off by imperceptible degrees into the 'procedural', and that the 'line' between them does not 'exist', to be discovered merely by logic and analysis, but is rather to be drawn so as best to carry out our purpose"). Cook also notes that the question is not where one can find the objective line separating substance from procedure but where to draw the line. *Id.* at 335; *see also* Larry Kramer, *Rethinking Choice of Law*, 90 COLUM. L. REV. 277, 325-36 (1990) (arguing that characterization of substance versus procedure depends on their purpose). Further, even attempts to draw the line based on identifying the purpose of the norm—thus distinguishing between norms that regulate behavior during litigation versus behavior unrelated to litigation—cannot escape this difficulty because some norms do both. Consider, for example, a statute of limitations, the purpose of which is both to allow defendants to free reserved resources they kept for reasons of possible exposure to liability (a substantive behavior) and to prevent defendants from having to defend themselves with out-of-date evidence (a procedural behavior).

42. Adopting a rationale-based characterization to distinguish substance from procedure also solves the problem of deciding what to characterize—a specific factual dispute or a rule of law. For a discussion of this problem, see Panagopoulos, *supra* note 2, at 73-75.

2. The Rationales

While it is not an easy task to trace a discussion of the legitimacy of each rationale that can mobilize the substance-procedure distinction, let alone of the interaction between them, consider the following rationales.

Power. From a historic viewpoint, the substance-procedure distinction was probably formed to promote a rather narrow rationale.[43] As with any other governmental agency, the court does not enjoy unlimited power. This is particularly the case when the plaintiff asks the court to impinge on the defendant's assets or rights. Thus, although the case before the court may be entwined with foreign elements, the forum court nevertheless lacks power to extend remedies that it is not authorized to issue by local law. In other words, the court's collection of remedies does not expand merely because the case before it is of an international nature. Thus, commentators have noted that "[t]he lex fori must regulate procedure, because the court can only use its own procedure, having no power to adopt alien procedures. To some extent, at any rate, the lex fori must regulate remedies, because the court can only give its own remedies . . . ."[44]

Inconvenience. A more functional reason to explain the substance-procedure distinction is, again, a rather narrow rationale: protecting the local court from being unduly burdened and inconvenienced by the need to apply foreign law to certain specific disputes.[45] Facing the need to apply foreign law in a particular litigation, the rationale echoes "an obvious practical necessity"[46] and envisions situations in which the forum is called to apply foreign law even when application of such foreign law burdens the court immensely.

In this context, one can depict several scenarios that the literature addresses:

> (1) The forum entertains a different procedure than the one that exists under the lex causae. A classic example would be the issue of trial management. Consider a defendant in a judicial system in which civil litigation takes place before a judge, who argues that the complaint against him should be heard before a jury. To illustrate, suppose the defendant is of foreign domicile and the complaint was filed against him for a tort that occurred in the foreign jurisdiction, which bestows upon defendants the right to be adjudged by a jury of their peers. Obviously, from an institutional viewpoint, the courts of forum are incapable—even physically—of conducting a trial in such manner. Thus, characterizing the issue, or dispute, regarding trial management as procedural brings with it the application of

43. *See, e.g.*, *Erie R.R. Co.*, 304 U.S. at 79; Thomas O. Main, *The Procedural Foundation of Substantive Law*, 87 WASH. U. L. REV. 801, 809 (2010).

44. *See* Boys v. Chaplin, [1971] A.C. 356, 394 (Lord Pearson).

45. *See* COLLINS ET AL., *supra* note 24, at 178 (U.K.); Cook, *supra* note 39, at 344 ("[O]ur problem resolves itself substantially into this: How far can the court of the forum go in applying the rules taken from the foreign system of law without unduly hindering or inconveniencing itself?") (U.S.). For a detailed history of the substance-procedure distinction, see Illmer, *supra* note 36, at 239-41; Main, *supra* note 43, at 804-11.

46. W. E. Beckett, *The Question of Classification ("Qualification") in Private International Law*, 15 BRIT. Y.B. INT'L L. 46, 66 (1934).

forum law and rejection of the defendant's argument.[47] Commentators have further argued in this context that when considering the doctrinal justification for entertaining the distinction between substance and procedure, one should keep in mind that certain procedural norms tend to be rather complicated in themselves and that interweaving them with existing forum procedures would excessively burden the local court.[48]

(2) The forum does not have a procedure at all because the forum does not have a cause of action to which such procedure would be attached. An example would be a case in which the plaintiff files a complaint to the court building his case upon a cause-of-action unknown by forum law and relying accordingly on a special procedure, which, of course, is also unknown to the forum.[49]

(3) Uncertainty as to the nature of procedure to be employed by the forum, especially prior to the trial commencing and before the relevant lex causae has been chosen, pleaded, and proven. In such a case, it is unclear with which procedure the litigants should originally approach the court.[50]

(4) Another situation that falls under this category of inconveniencing the forum court concerns the issue of dépeçage, which is the possible split and application of different laws to different specific disputes that arise during a single litigation.[51] Once courts are willing to entertain such a split, a question arises as to which law should regulate the procedure in such litigation. Suppose, for example, that pertinent choice-of-law rules direct the U.K. forum to apply in a particular litigation French law to one specific dispute (e.g., a dispute regarding the question of capacity to enter a contract) and Japanese law to another specific dispute (e.g., a dispute over the interpretation of the contract). In such a case, can either of these two foreign laws be chosen to regulate matters of procedure, such as trial management? Even if one would be willing to consider such an option, which calls for having the trial management norms of one jurisdiction apply alongside the substantive norms of a different jurisdiction, how should the forum court decide which of the two foreign laws actually ought to apply? Should the forum court prefer the trial management law of one of these jurisdictions to the trial management law of the other? The inevitable conclusion that solves this problem and makes sense is to resort to the forum law regarding matters of procedure.[52]

(5) A forum court, the caseload of which consists of many disputes that give rise to choice-of-law questions in general and to the application of foreign law in particular, cannot be expected to apply, for instance, in one litigation a French procedure, in a second litigation a Japanese procedure, and in a third litigation a Canadian procedure.[53]

However, despite the many possible scenarios, one can identify a change occurring with regard to the scope of this rationale and the manner

47. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 122-144 (1971); RESTATEMENT (FIRST) OF CONFLICT OF LAWS § 594 (1934).

48. *See* Carruthers, *supra* note 38, at 692.

49. *See, e.g.*, Kramer, *supra* note 41, at 304-05; Main, *supra* note 43, at 802.

50. *See, e.g.*, Giesela Rühl, *Methods and Approaches in Choice of Law: An Economic Perspective*, 24 BERKELEY J. INT'L L. 42, 48-49 (2006).

51. *See* COLLINS ET AL., *supra* note 24, at 1555-58 (discussing and explaining dépecage); CURRIE ET AL., *supra* note 4, at 244 (discussing and explaining dépecage).

52. *See* Gray, *supra* note 38, at 284.

53. *See* Beckett, *supra* note 46, at 66.

in which it is implemented. Recent comments in the literature suggest that courts have begun to realize that applying this rationale too widely would frustrate conflict-of-laws principles, particularly the two goals of deterring forum shopping (with regard to plaintiffs' selection of venues) and neutrality (with regard to the choice-of-law methodology).[54] In other words, being too protective of the forum court in this context (which means that the "procedure" tag is attached too hastily) comes with a price: the forum's own conflict-of-laws agenda would be increasingly thwarted. In accordance with this theme, commentators have advocated for the adoption of neutrality as a criterion for striking the substance-procedure characterization.[55] Neutrality should be "determined by the abstract nature of the matter in question, not by reference to the concrete case."[56] To illustrate, consider the issue of estoppel. Resorting to neutrality generates the conclusion that while estoppel-by-record should be characterized as procedural and governed by forum law because it is intended to prevent contradictory judicial decisions, other forms of estoppel are concerned with the decision on the merits, as they relate to the specific dispute and should be regarded as substantive.[57]

Expectations. Similar to the inconvenience rationale, yet different in principle, is the rationale of litigants' expectations. It has been argued that the forum should apply its own law to specific disputes over procedure because such application comports to the litigants' post-dispute expectations.[58] Such a rationale particularly addresses the plaintiff, who chooses the forum court and thus must accept the forum court's procedure.[59]

Efficiency. Over the years, the rationale for employing the substance-procedure distinction has evolved in several directions.[60] One direction can be summarized as a concern with enhancing efficient litigation.[61] Currently, matters of procedure are hardly considered insignificant;[62] therefore, one would find it hard to argue that matters of procedure should be decided according to forum law simply because they are unimportant. It is, nevertheless, possible to argue that the application of forum law in certain matters is justified as a means of saving the time and costs associated with applying a foreign law in a civil litigation. Indeed, a good argument can be brought in support of refraining from applying foreign law to each trivial dispute that arises during the trial, such as the type of paper on which the parties' arguments should be typed. In other words, this ratio-

54. *See* Gray, *supra* note 38, at 283 n.22; Illmer, *supra* note 36, at 250.

55. Illmer, *supra* note 36, at 246-47.

56. *Id.* at 246.

57. *Id.* at 257.

58. *See* Carruthers, *supra* note 38, at 693-94 (identifying Wolff as endorsing this rationale).

59. *Id.*

60. *See supra* notes 43, 58 and accompanying text. *See generally* Carruthers, *supra* note 38.

61. *See* Main, *supra* note 43, at 833.

62. *See, e.g., id.* at 802 (generally emphasizing that "procedural" norms are powerful enough to undermine "substantive" rights).

nale calls on courts to economize on the costs associated with application of foreign law.

Efficiency in this context means simplifying as much as possible the adjudication of the dispute and minimizing its costs. First, from the court's viewpoint, jurists are usually unfamiliar with any foreign law under consideration for application, and, if application is unnecessary, they should not be forced to learn the intricacies, ideology, and other factors relevant to that law. Such a learning process entails a waste of precious judicial time. Moreover the choice of legal process itself may be considered quite expensive in terms of judicial time wasted because many judges dislike this area of the law. Characterizing a norm or a specific dispute as procedural, rather than substantive, has in practice the immediate effect of invoking the forum law without the necessity of engaging in the choice-of-law process.

Furthermore, when viewed from a social perspective that concerns itself with the litigating parties' expenses, the costs of proving foreign law can be quite significant, especially in those systems of law in which foreign law is an issue of fact, rather than of law.[63] In these legal systems, proving foreign law necessitates evidence—usually the testimony of witnesses who are experts on the foreign law in question—that is relatively expensive to obtain. Expert witnesses are required to submit written opinions and later are called into court to testify on such opinions and to be cross-examined.[64] The entire process becomes even more expensive if one of the parties to the litigation calls as his expert witness a foreign witness, such as a foreign law professor or a lawyer. Conventional treatment would no doubt include the need to provide such a witness with airfare, proper hotel accommodations, and dining. Application of foreign law may mandate employing more than one expert witness, as litigants would like their expert to rebut the testimony of their opponent's expert. When two experts disagree on a matter in which the court has little understanding—in this case, the contents of a particular foreign law—one can expect that the court will react by appointing a third expert, this time on behalf of the court.[65]

Whether the trial takes place in a system in which legal expenses cannot be shifted and parties to a civil litigation bear their own legal expenses or in a system in which the loser at the trial bears the legal expenses, duplicate expert testimonies are socially wasteful. Assuming that the purpose of the litigation is first and foremost to find the truth and uphold a just result between the parties litigating, one would like to achieve these goals as cheaply as possible.

Of course, a question arises as to how courts should guide themselves in promoting the efficiency rationale. In other words, the question is what criterion courts should employ to decide that a characterization of proce-

63. *Id.* at 833.

64. *See generally* Roger M. Michalski, *Pleading and Proving Foreign Law in the Age of Plausibility Pleading*, 59 BUFF. L. REV. 1207 (2011).

65. *Id.*

dure is in order for reasons of efficiency. Obviously, a cost-benefit analysis is in order. However, what kind of analysis? The case law and the literature have yet to answer that question.

Tool. Perhaps the most intriguing and controversial direction in which the substance-procedure distinction has advanced in the conflict-of-laws context—mostly in systems retaining the traditional choice-of-law doctrine—is usually only implicitly mentioned: the direction of policy-oriented rationale. On several occasions, it has been posited that the court exercising the choice-of-law decision should employ the substance-procedure distinction as a tool to allow various policy considerations to be inserted into the otherwise neutral, and thus perhaps unsatisfying, choice-of-law process.[66]

The idea underlying this rationale is to use the substance-procedure distinction in a functional manner to manipulate the choice-of-law process. The substance-procedure distinction, advocates argue, should be perceived merely as a tool, the purpose of which is to enrich the choice-of-law process with policy considerations. These policy considerations usually belong to one of two groups: substantive policy considerations or policy considerations that concern choice-of-law methodology.[67]

To illustrate the importance of this rationale and the manner in which courts are expected to apply it, consider a rather extreme example. Suppose a vessel documented in Panama is the subject of two types of claims filed before the forum court by creditors of the vessel's owners.[68] Creditor *S*'s claim is a secured claim because a ship mortgage has been recorded in his favor to guarantee that the underlying claim against the vessel's owner is paid. Creditor *U*'s claim is seemingly an unsecured claim, but Creditor *U* argues that the claim arose through the act of providing the vessel with a service (e.g., food, towing, working, etc.), the result of which arguably was the creation of an (unrecorded) maritime lien[69] that secures payment of his

66. *See* Roerig v. Valiant Trawlers Ltd, [2002] 1 Lloyd's Rep. 681, 688 ("In my view the question whether deductions of benefits should be made is likely to be bound up both with policy considerations and with the way in which damages under the particular head are to be assessed overall.") (Waller L.J.); Harding v. Wealands, [2007] 2 A.C. 1, 8 ("A wide definition of what is procedural tends to defeat the purpose of the law of the country whose law is to be applied and encourages forum shopping, reduces comity and gives rise to anomalous and unjust results . . . .") (Lord Hoffman); Hakeem Seriki, Harding v. Wealands–*The Final Word on Assessment of Damages Under English Law?*, 26 C.J.Q. 28, 29 (2007) ("[A] better reason for classification [as procedural] is that an English court must retain control over the remedies it gives to a litigant in its jurisdiction, and one way of achieving this is by only giving remedies allowed under English law."); CA 352/87 Greifin Corp. v. Kur Sa'har Ltd., 44(3) PD 45, 76-77 [1990] (Isr.).

67. *See generally Roerig*, 1 Lloyd's Rep. 681.

68. *See, e.g.*, Bankers Trust Int'l Ltd. v. Todd Shipyard Corp., [1980] 3 All E.R. 197 (P.C.) (Eng.); CA 352/87 *Greifin Corp.*, 44(3) PD at 45.

69. A maritime lien is a statutory lien, usually unrecorded, created even in the absence of a contractual agreement between the creditor and the debtor (the vessel's owners), the purpose of which is to secure payments owed by the vessel's owners to his otherwise unsecured creditors when their claims originate as a result of the vessel incurring operating expenses. Creditors holding a maritime lien can sue the vessel in rem for its value, as well as sue its owners in personam. *See generally* Raymond P. Hayden &

claim. The two creditors, whose claims against the vessel are mutually exclusive because the total sum of the claims exceeds the vessel's net worth, are in dispute over two specific issues. First, is Creditor *U*'s claim indeed secured by a maritime lien? If Creditor *U*'s claim is not guaranteed with a maritime lien, it is merely an unsecured claim that Creditor *S*'s claim obviously outranks. Indeed, one can understand Creditor *U*'s position: the only way in which Creditor *U*'s claim can outrank Creditor *S*'s claim is if Creditor *U*'s claim is guaranteed with a maritime lien. Otherwise, Creditor *U*'s claim, as an unsecured claim, is to be paid only once Creditor *S*'s claim is paid in full (which is impossible). Second, if Creditor *U*'s claim is indeed secured with a maritime lien, which of the secured claims should prevail? Does creditor *S*'s claim outrank Creditor *U*'s claim, or vice versa? Which of the two claims ranks higher on the order of priorities?

Issues of choice-of-law arise as it becomes clear that with regard to each of these specific disputes, each of the creditors holds a different position as to the law that applies. Creditor *U* argues that forum law applies to the first specific dispute, thus acknowledging the claim as being secured by a marine lien. Creditor *S* argues that the law of State X regulates this dispute instead, and State X law does not acknowledge a maritime lien when the claim originates in a voluntary service rendered by the claimant to the vessel (as opposed to a claim of an involuntary creditor, i.e., one resulting from a tortious act). As for the second specific dispute—which concerns the order of priorities between the two claims—Creditor *U* argues for the application of a law according to which maritime liens outrank any marine mortgage, while Creditor *S* argues for the application of the forum law, which recognizes the superiority of the ship mortgage over the maritime lien.

How should this case be decided according to the policy considerations insertion rationale? Israeli law has, for example, supplied an answer. In a case decided by the Israeli Supreme Court in 1990, Justice Shoshana Netanyahu introduced this rationale, ruling that both specific disputes should be characterized as procedural and thus be decided according to the law of the forum (which in that case, while acknowledging Creditor *U* claim's secured status, mandated that it be outranked by the ship mortgage, therefore making Creditor *S*'s claim outrank Creditor *U*'s claim).[70] The Justice explained that the "procedure" characterization ought to be chosen because the court should, in this particular case, take certain specific policy considerations into account. For example, in regard to the first specific dispute concerning the question of the possible formation of a maritime lien, the Justice ruled that at least two policy considerations call the court to opt for a "procedure" characterization, the first of which was the need to reduce the number of maritime liens. The Justice stated that while the forum law—i.e., Israeli law—is known for having a minimal number of maritime liens (which, as a matter of maritime law or property law

Kipp C. Leland, *The Uniqueness of Admiralty and Maritime Law: The Unique Nature of Maritime Liens*, 79 TUL. L. REV. 1227 (2005).

70. CA 352/87 *Greifin Corp.*, 44(3) PD at 45.

are generally considered unwarranted and to reduce overall welfare), characterizing the dispute as one of substance may result, at least in future cases, in application of a foreign law. However, the application of foreign law may result in the forum court acknowledging a far larger number of maritime liens than "is warranted."[71] Second, the Justice pointed to a need to simplify the choice-of-law process. In this context, Justice Netanyahu stated that when considering application of foreign law to the issue of creation of an entitlement, one familiar with choice-of-law methodology should think of the next stage—ranking the entitlement according to an order of priorities—and refrain from enabling the application of a foreign law.[72] Indeed, the Justice explained that because the forum law should regulate the dispute concerning the order of priorities, so should the dispute with regard to the creation of the entitlement. Otherwise, the court might have to decide where along the order of priorities an unfamiliar entitlement should be ranked. Moreover, because the forum law regulates the order of priorities, forum law should also regulate the question of whether an entitlement of some sort exists at all to prevent confusion.

One ought to note that those advocating the idea of utilizing the substance-procedure distinction as a tool to insert policy considerations into the choice-of-law process are actually arguing for a completely open and acknowledged manipulation of this process, one that differs immensely from any hidden manipulation of the choice-of-law process to which critics sometimes refer.[73] Thus, it is argued, the court making the choice-of-law decision should explain and disclose for review the policy considerations that are inserted into the choice-of-law process.

C. The Public Policy Doctrine

The traditional choice-of-law process calls upon the judge to characterize the specific dispute or disputes brought before it and with regard to each dispute follow the link associated with the resulting characterization.[74] The judge is thus directed to apply the law of one jurisdiction to the characterized specific dispute. However, if at the end of this process the judge reaches the conclusion that the applicable law is foreign, he may, nonetheless, refrain from applying that law by ruling that such an application would be inconsistent with the forum's public policy.[75]

The public policy doctrine ("*ordere public international*") prevents the application of foreign law (or judgment) in as much as its application is inconsistent with what the forum considers to be "some fundamental principle of justice, some prevalent conception of good morals, some deep-

71. *Id.*
72. *Id.*
73. *See, e.g.*, Boys v. Chaplin, [1971] A.C. 356, 392 ("It may be that this appeal can be decided, quasi-mechanically, by the accepted distinction between substance and procedure . . . . I have no wish to depreciate the use of these familiar tools. In skillful hands they can be powerful and effective . . . .") (Lord Wilberforce).
74. *See, e.g.*, BRIGGS, *supra* note 24, at 8-10.
75. *See, e.g.*, COLLINS, *supra* note 24, at 92-100.

rooted tradition of the common weal."[76] In other words, in the conflict-of-laws process, the public policy doctrine is the forum's way of stating that the forum's tolerance of foreign laws (or judgments) and the forum's respective willingness to apply them is not without limits. For example, a particular foreign law, the application of which under the circumstances is intolerable from the forum's viewpoint, shall not be applied. However, the public policy doctrine also reveals that the forum is willing, at least to a certain extent, to tolerate applicable foreign legal arrangements and regulations that differ from the forum's own standard norms. Indeed, mere difference between an applicable foreign legal norm and the forum's own norms should ordinarily be an insufficient cause to ignore the foreign norm and should *not* bring about the application of the forum's norms instead of the foreign norm.

While always suspect due to its propensity to generate uncertainty because of its flexible nature,[77] the doctrine is an important escape hatch, allowing the forum court to avoid being forced to apply a foreign law which, in light of its contents, the forum court considers unwarranted. Some consider the public policy doctrine rather useful.[78] Thus, an argument put forward as early as the 1940s called for replacing the substance-procedure distinction with a wider application of the public policy doctrine.[79] Such a doctrinal replacement would eliminate the need to grapple with the substance-procedure distinction but would, nonetheless, enable the forum to apply its own law to the specific issue. Most legal systems, however, have not adhered to this proposal.

Regardless, courts naturally tend to gravitate toward practical solutions to the legal problems they face, and the problem of uncertain public policy doctrine is no different. In an attempt to transform the doctrine into a more practical and predictable tool, a commentator has recently argued that the public policy doctrine should continue to evolve along an already existing trend of being employed to block applicable foreign norms only sparingly. To that end, it has been suggested that three principles should serve to guide the court.[80] We consider these principles in detail because understanding them can, at the least, shed light on the nature of

76. *See* Loucks v. Standard Oil Co. of N.Y., 120 N.E. 198, 202 (N.Y. 1918).

77. *See, e.g.*, Mills, *supra* note 28, at 202-03; Monrad G. Paulsen & Michael I. Sovern, *"Public Policy" in the Conflict of Laws*, 56 COLUM. L. REV. 969, 971-73, 981 (1956).

78. *See*, e.g., Enderby Town Football Club Ltd. v. Football Association Ltd., [1971] 1 All E.R. 215 at 219 (Lord Denning) (noting the ability of the doctrine, which was famously compared to an "unruly horse," to "jump over obstacles . . . and come down on the side of justice").

79. *See* Edmund M. Morgan, *Choice of Law Governing Proof*, 58 HARV. L. REV. 153, 195 (1944). Advocating a moderate version of the argument, Morgan suggests that the law of the locus should apply to all matters of substance (except where its application would violate the public policy of the forum) and to all matters of procedure that are likely to have a material influence upon the outcome (except when its application will violate the public policy of the forum or when "weighty practical considerations" demand the application of the law of the forum).

80. *See* Mills, *supra* note 28, at 210-18.

this doctrine. The first principle is proximity. The forum court should examine its proximity to the specific dispute to justify the execution of regulatory authority. For example, when the litigating parties are both foreigners who are fighting over a foreign transaction with purely foreign implications, the forum should usually not consider itself in near enough proximity to justify invoking public policy considerations. The second principle is relativity. The forum court should examine the nature of the norms from which the applicable foreign law diverges, particularly the extent to which such norms are perceived by the forum as absolute or merely local. For example, a foreign law violating internationally recognized human rights appears to be inherently inconsistent with the forum's public policy, whereas a norm entertained exclusively by the laws of the forum usually should not be considered inconsistent with the latter's public policy. The third principle concerns the seriousness of the breach. The forum court should examine the extent of the divergence between the applicable foreign law and the protected norm. In particular, the forum court must examine whether the breach is minor and technical or fundamental. For example, a slight difference in the scope of money damages awarded by the foreign law in comparison to damages usually awarded by forum law should not generally constitute a serious breach of any norm and, thus, should not trigger the invocation of the public policy doctrine.

D. The Presumption against Extraterritoriality

The presumption against extraterritoriality is preoccupied with the extraterritorial application of local laws, particularly those with regulatory purposes, to cases involving foreign jurisdictions. The doctrine calls upon the forum court to construe local regulation as having no application outside the territory of the forum unless a contrary legislative intent can be inferred.[81] The doctrine mirrors a merger of two rules of construction:[82] first, a rule according to which statutes should be construed not to violate international law and, second, a rule according to which jurisdiction is generally territorial. To better understand the presumption, consider its theoretical foundations and the manner in which it evolved.

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81. *See, e.g.*, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010) (applying U.S. doctrine with relation to federal statutes); *see also* Lea Brilmayer, *The New Extraterritoriality:* Morrison v. National Australia Bank, *Legislative Supremacy, and the Presumption Against Extraterritorial Application of American Law*, 40 SW. L. REV. 655 (2011) (criticizing the U.S. Supreme Court's decision for leaving a loophole which allows extraterritorial application: the presumption can indeed be rebutted, but it can also be declared inapplicable if shown that the case at hand is not of foreign, but rather of local, focus); Stephen J. Choi & Linda J. Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465 (presenting discussion before the U.S. Supreme Court decision in *Morrison*); Erez Reuveni, *Extraterritoriality as Standing: A Standing Theory of the Extraterritorial Application of the Securities Laws*, 43 U.C. DAVIS L. REV. 1071 (2010) (same).

82. *See* William S. Dodge, Morrison's *Effects Test*, 40 SW. L. REV. 687, 687 (2011).

1. *Territoriality*

One could assume a need for jurisdictions worldwide to divide amongst themselves authority and regulation[83] as well as to inform people—who naturally possess tendencies to both accumulate property and travel across borders—to which authority they answer at any given moment. One could also accept that looking to physical borders would be a rather simple, reasonable, and equitable way to accomplish such horizontal and vertical divisions of power.[84] Thus, as early as the seventeenth century, scholars began to articulate what had already become a reality even before: specifically, that geographical borders as a concept is a focal point around which various power-dividing norms can be formed.[85] A principle of territoriality was thus enunciated to argue that "the laws of each state have force within the limits of that government and bind all subject to it, but not beyond."[86] The idea of extraterritoriality was also beginning to evolve, even if for practical reasons alone: sovereign states needed to communicate with each other using ambassadors, and embassies became preliminary islands of foreign territory that the host jurisdiction accepted.[87]

Note that these ideas have evolved in an environment in which constant tension already existed between each jurisdiction's technical ability to become as imperialistic in its approach as it wished, notwithstanding the practical results of such an approach, and the need of each jurisdiction to defend itself against retaliatory behavior by other jurisdictions. For example, a legislature can, subject to constitutional limitations, act as "imperialistically" as it wishes, but must also take into account international criticism and possible retaliation by other jurisdictions. Moreover, occasionally—for example, in most contexts of private international law—any inter-jurisdictional tension has to be relieved not by jurisdictions conversing with one another but rather through forming norms unilaterally.[88]

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83. *See, e.g.*, Hannah L. Buxbaum, *Conflict of Economic Laws: From Sovereignty to Substance*, 42 VA. J. INT'L L. 931, 932-33 (2002) (describing the growing potential for regulatory conflicts in the modern world).

84. *See* KAL RAUSTIALA, DOES THE CONSTITUTION FOLLOW THE FLAG? THE EVOLUTION OF TERRITORIALITY IN AMERICAN LAW 5 (2009) (discussing territoriality as an intuitive organizing principle); *see generally* John Agnew, *Territoriality*, *in* THE DICTIONARY OF HUMAN GEOGRAPHY 744 (Derek Gregory et al. eds., 5th ed. 2009) (same).

85. For a discussion highlighting important historical aspects, see CURRIE ET AL., *supra* note 4, at 2-14 (discussing the context of private international law); RAUSTIALA, *supra* note 84, at 10-12 (noting that the Treaty of Westphalia of 1648 and the subsequent emergence of related ideas as a turning point in history, replaced a regime of personal jurisdiction with a territorial one, and also discussing pre-Westphalian manifestations of territoriality).

86. CURRIE ET AL., *supra* note 4, at 3 (quoting a translated version of words by the Dutch scholar Ulrich Huber); *see also* JOSEPH STORY, COMMENTARIES ON THE CONFLICT OF LAWS FOREIGN AND DOMESTIC 7 (Keip Verlag 2007) (1834).

87. *See* RAUSTIALA, *supra* note 84, at 13.

88. For example, in the area of foreign country judgments, the United States has not joined any bilateral or multilateral convention. *See* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW 592 n.1 (1987) (discussing failed bilateral convention negotiations between the United States and Great Britain); Brian R. Paige, Comment, *Foreign Judg-*

To the extent that jurisdictions consider one another as equals[89] and would prefer not to draw fire and retaliation from other jurisdictions, there appears to be no better criterion than territory to divide regulatory power amongst them. Over the years, the territorial criterion has thus evolved as a self-imposed meta-norm manifesting itself in various public and private international law contexts as a decision-making rule.[90] For example, it is well-known in the private international law context that jurisdiction to adjudicate private disputes is generally territorial[91] and that the location of an act determines the law applicable to that act.[92] It is also well-accepted that foreign laws are assumed to apply only within the territory in which they were enacted.[93] Finally, it is also well-acknowledged in both private and public international law contexts that Congress's jurisdiction to legislate (i.e., prescriptive jurisdiction) is also territorial and that laws should be construed in accordance with a presumption against extraterritoriality.[94] This latter canon is particularly important because it usually serves as the legal framework within which decisions by courts on the extraterritorial application of economic regulation are made. A typical case brought before the courts involves a set of facts with mixed foreign and domestic contacts and an assertion by a plaintiff that a specific norm dictated by the local economic regulation web applies, thus awarding the plaintiff with a cause of action.[95]

2. *Why Territoriality?*

Various rationales for employing the territorial criterion have been offered over the years. These rationales mainly work in two directions. *First*, to impose on the local courts a regime of compliance with the norms of international law or with the interests of other jurisdictions. Rationales using this line of thought are meant to restrain the forum from becoming

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ments in American and English Courts: A Comparative Analysis, 26 SEATTLE U. L. REV. 591, 622 (2003).

89. *See, e.g.*, Schooner Exch. v. McFaddon, 11 U.S. 116, 136 (1812).

90. Note, however, that Congress may rebut these rules.

91. *See* Pennoyer v. Neff, 95 U.S. 714, 720 (1877). Again, legislatures can override this limitation, subject to constitutional constraints. *See also* Int'l Shoe v. Washington, 326 U.S. 310 (1945).

92. *See, e.g.*, KERMIT ROOSEVELT, III, CONFLICT OF LAWS 6-12 (2010) (discussing the choice of law rules of *lex loci delicti commissi* and *lex contractus*).

93. *See* Hilton v. Guyot, 159 U.S. 113, 163 (1895); *Pennoyer*, 95 U.S. at 722-23; *see also* Mount Albert Borough Council v. Australasian Temperance & Gen. Mut. Life Assurance Soc'y, [1938] A.C. 224 (P.C.) (appeal taken from N.Z.)

94. *See* Am. Banana Co. v. United Fruit Co., 213 U.S. 347, 357 (1909). *See* also David L. Sloss et al., *International Law in the Supreme Court to 1860, in* INTERNATIONAL LAW IN THE U.S. SUPREME COURT: CONTINUITY AND CHANGE 7, 37-38 (David L. Sloss et al. eds., 2011) (noting that the presumption against extraterritoriality is a merger of the canon that statutes should be construed not to violate the law of nations (Murray v. Schooner Charming Betsy, 6 U.S. 64, 118 (1804)) and the rule according to which jurisdiction is generally territorial).

95. When the plaintiff is a private agent, and the lawsuit is of a civil nature, regulation is decentralized and accomplished in a private ordering regime. When the "plaintiff" is an administrative or a law enforcement agency and the "lawsuit" concerns administrative or criminal proceedings, regulation is administrative.

too imperialistic in its approach to regulation of transnational activities. This rationale is a school of thought demonstrating understanding and tolerance for the needs of both other jurisdictions and the general international order.[96] For example, one of the rationales supporting the presumption against extraterritoriality is comity.[97] Another justification for the presumption is the prevention of unintentional discord with other jurisdictions.[98] It has been emphasized that the territorial criterion, due to its formal and rigid nature, possesses the potential to prevent overlapping regulation.[99] Extraterritorial application of forum law, however, would interfere with attempts by other jurisdictions to regulate in particular events that take place in their own territory.[100] Some view the territorial criterion as a spontaneous measure employed to restrain civil justice systems, such as the American one, that are known for granting private plaintiffs relatively high awards.[101]

It should be noted, however, that there has been a change in the extent to which these rationales have maintained their persuasiveness. For example, the U.S. Supreme Court has noted the irrelevance of these rationales in its deliberations, making clear that the presumption against extraterritoriality "applies regardless of whether there is a risk of conflict between the American statute and a foreign law."[102] Moreover, an approach respecting other jurisdiction's regulatory interests sometimes creates a regulatory gap because not all jurisdictions have an appropriate regulatory regime addressing, for example, anti-competitive behavior.[103]

A *second* and perhaps more persuasive[104] direction in which legal rationalization evolved was to echo a predisposition to focus on one's own internal affairs. For example, one of the rationales for the presumption against extraterritoriality in this school is that the legislator is mainly con-

96. *See* e.g., F. Hoffmann-La Roche Ltd. v. Empagran S.A., 542 U.S. 155, 164-65 (2004).

97. *See Am. Banana Co.*, 213 U.S. at 356; *see also* EEOC v. Arabian Am. Oil Co. (*Aramco*), 499 U.S. 244, 248 (1991).

98. *See Aramco*, 499 U.S. at 248.

99. See William S. Dodge, *Extraterritoriality and Conflict-of-Laws Theory: An Argument for Judicial Unilateralism*, 39 HARV. INT'L L.J. 101, 123 (1998).

100. *See, e.g.*, F. Hoffmann-La Roche Ltd. v. Empagran S.A., 542 U.S. 155, 165, 169 (2004); N.Y. Cent. R.R. Co. v. Chisholm, 268 U.S. 29, 31-32 (1925).

101. *See* Paul B. Stephan, Empagran: *Empire Building or Judicial Modesty?*, *in* INTERNATIONAL LAW IN THE U.S. SUPREME COURT: CONTINUITY AND CHANGE, *supra* note 94, at 553, 554-55.

102. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2877-78 (2010); *see also* William S. Dodge, *Understanding the Presumption Against Extraterritoriality*, 16 BERKELEY J. INT'L L. 85, 114 (1998) (noting that modern international law allows jurisdictions to extend local laws in an extra-territorial manner).

103. *See* Ralf Michaels, Empagran's *Empire: International Law and Statutory Interpretation in the U.S. Supreme Court of the Twenty-First Century*, *in* INTERNATIONAL LAW IN THE U.S. SUPREME COURT: CONTINUITY AND CHANGE, *supra* note 94, at 533, 542.

104. *See Morrison*, 130 S. Ct. at 2877-78 (noting that the presumption against extraterritoriality applies even in cases in which a conflict between U.S. and a foreign law exists). However, it has been suggested that this line of reasoning is "teleological" and, therefore, it is unclear what in fact justifies the presumption against extraterritoriality. *See* Michaels, *supra* note 103, at 540.

cerned with domestic issues.[105] While the precise motive for such disposition has not been specifically explained, clearly it has to do with conserving scarce regulatory resources,[106] or with a more vague philosophical idea of minding your own business while letting others mind their own. Another rationale concerns the integrity of the forum jurisdiction's foreign relations.[107] The idea is that rather than being merely respectful of other jurisdictions' interests, the forum should behave cautiously and refrain from excessive extraterritoriality to serve its own purpose of maintaining stable foreign relations. Another argument focuses on the role of courts in the political system, contending that a narrow territorial approach may be to avoid international criticism of a policy shaped by a court without the participation of the political branches.[108] Moreover, it has been suggested that a legislature should exclusively control the extraterritorial application of its laws; thus, courts should, for the most part, adopt a deferential position, which the presumption against extraterritoriality allows them to take.[109]

3. *Versions of Territoriality*

A territorial criterion attempting to localize a particular set of facts—mostly in cases demonstrating a mixture of both domestic and foreign contacts—is not always easy to apply, particularly in a globalizing and technologically advanced world.[110] The problem is further exacerbated by the increasingly sophisticated nature of current economic activity, which employs fictitious entities such as corporations or trusts and involves transactions with significant contacts with several jurisdictions simultaneously. Most jurisdictions have long ago opted for territoriality, leaving open only the question of which version to adopt: narrow territoriality or extraterritoriality.[111]

Against this backdrop, American case law, for example, gradually began to apply a rather flexible criterion upon which authority to regulate economic workings in the inter-sphere can be divided among jurisdictions. Most notable in this context is the "effects test," which calls upon courts to

105. *See* Small v. United States, 544 U.S. 385, 388-89 (2005); EEOC v. Arabian Am. Oil Co. (*Aramco*), 499 U.S. 244, 248 (1991); Foley Bros. v. Filardo, 336 U.S. 281, 285 (1949).

106. *See, e.g.*, Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 985 (2d Cir. 1975) ("... whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to [predominantly foreign claims] rather than leave the problem to foreign countries").

107. *See* Kahn, *supra* note 31, at 370.

108. *See* Curtis A. Bradley, *Territorial Intellectual Property Rights in an Age of Globalism*, 37 VA. J. INT'L L. 505, 508-09, 550-62 (1997).

109. *See* Microsoft Corp. v. AT&T Corp., 550 U.S. 437, 458-59 (2007).

110. *See* RAUSTIALA, *supra* note 84, at 8-9 (discussing the relative relevance of the "flat world" thesis, according to which "political boundaries matter little and economic and social forces move freely").

111. *See* RAUSTIALA, *supra* note 84, at 95-125 (discussing the broader ideological background against which "extraterritoriality" evolved—e.g., the rise of the regulatory state).

apply U.S. regulations whenever a foreign conduct causes effects in the United States[112] The effects test has been applied in various contexts of economic regulation.[113] For example, the effects test has been employed in the antitrust context, beginning in the courts[114] and later Congress, as it enacted the Foreign Trade Antitrust Improvements Act of 1982, which holds that U.S. antitrust law does not apply to "conduct involving trade or commerce . . . with foreign nations unless . . . such conduct has a direct, substantial, and reasonably foreseeable effect" in the United States.[115]

However, an alternative approach can also be pursued, as the United States recently demonstrated. With regard to securities antifraud regulation legislation, lower courts in the United States applied the effects test, which requires proof of direct and substantial domestic effects before the U.S. antifraud laws can be applied, to decide whether U.S. law regulates transnational cases.[116] However, in the famous *Morrison* case, a rather surprising turn of events occurred. Despite a continuous, decades-long effort by the Courts of Appeals to devise decision-making principles that differ from the narrow version of the territorial criterion, the U.S. Supreme Court decided to abandon not only the effects test but also any other criteria upon which the territorial criterion in this context could be structured and instead reiterated its commitment to a narrow version of territoriality.[117]

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112. *See, e.g.*, Austen Parrish, *The Effects Test: Extraterritoriality's Fifth Business*, 61 VAND. L. REV. 1455, 1457-58 (2008) (explaining the test and noting that "[a]t the heart of most extraterritoriality cases lies the effects test"). Of course, courts have employed on occasion yet another notable test—the "conduct test." *See* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1334 (2d Cir. 1972) (introducing the conduct test). Still, for the purpose of the current paper and exposition of its argument, it is sufficient to juxtapose the *Morrison* ruling with the "effects test." Both tests, however, reflect a longstanding American position also incorporated in Sections 402 and 403 of the Restatement (Third) of Foreign Relations Law.

113. *See* Parrish, *supra* note 112 (detailing the contexts and referring to authorities).

114. *See* Cont'l Ore Co. v. Union Carbide & Carbon Corp., 370 U.S. 690, 704 (1962); United States v. Sisal Sales Corp., 274 U.S. 268, 276 (1927); Thomsen v. Cayser, 243 U.S. 66, 88 (1917); United States v. Aluminum Co. of Am., 148 F.2d 416, 444 (2d Cir. 1945).

115. 15 U.S.C. § 6(a)(I)(A) (2012); *see also* F. Hoffmann-La Roche Ltd. v. Empagran S.A., 542 U.S. 155 (2004); Hartford Fire Ins. Co. v. California, 509 U.S. 764, 796 (1993); William S. Dodge, *An Economic Defense of Concurrent Antitrust Jurisdiction*, 38 TEX. INT'L L.J. 27, 27-28 (2003); Andrew T. Guzman, *Is International Antitrust Possible?*, 73 N.Y.U. L. REV. 1501, 1506-08 (1998); Larry Kramer, Comment, *Extraterritorial Application of American Law After the* Insurance Antitrust Case: *A Reply to Professors Lowenfeld and Trimble*, 89 AM. J. INT'L L. 750, 752 (1995); Christopher Sprigman, *Fix Prices Globally, Get Sued Locally? U.S. Jurisdiction over International Cartels*, 72 U. CHI. L. REV. 265 (2005).

116. *See, e.g.*, Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 667 (7th Cir. 1998); Robinson v. TCI/USW W. Commc'ns Inc., 117 F.3d 900, 905 (5th Cir. 1997); Consol. Gold Fields PLC v. Minorco, S.A., 871 F.2d 252, 261-62 (2d Cir. 1989); Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 33 (D.C. Cir. 1987); Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 991 (2d Cir. 1975); Schoenbaum v. Firstbrook, 405 F.2d 200, 206-08 (2d Cir. 1968).

117. *See* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2881 (2010).

The approach taken by the Supreme Court in *Morrison* is narrower than any effects test approach because any cases in which the plaintiff can establish effects on the U.S. economy will not be regulated by American law—even if the claim is filed in a U.S. court[118]—if the transaction was executed abroad and does not concern securities listed on a U.S. exchange. This result holds even if the fraudulent behavior has a substantial effect on the U.S. economy or emerges out of conduct that occurred in the United States. However, the *Morrison* approach can also be broader than any effects test because it can lead to the application of U.S. law to cases that concern securities transactions executed in the United States but that do not have any significant effects on the United States. In this sense, the narrow territoriality criterion is a more rigid criterion than the effects test criterion.

The *Morrison* case and the Court's renewed commitment to a narrow territorial criterion left analysts (or should have left them)[119] somewhat baffled. In a modern and globalized world, it is not easy to explain a narrow territorial approach if it is applied to "phenomena that do not respect territorial boundaries."[120] Moreover, extra-territoriality has considerable benefits for a power such as the United States,[121] in addition to mitigating the costs associated with refraining from regulating foreign activities that affect U.S. markets.[122] Nonetheless, the U.S. Supreme Court decided to replace the rather understandable[123] extra-territorial approach with a self-

118. Note that the lawsuit may be filed abroad and that the foreign court may choose to apply U.S. law. The foreign court makes its decisions unilaterally without necessarily considering the U.S. position on the issue.

119. *See*, e.g., RAUSTIALA, *supra* note 84, at 125 (noting the discussion written before the Supreme Court rendered the *Morrison* decision: "[T]oday effects-based extraterritoriality is no longer questioned in its fundamentals, nor is it a purely American phenomenon. Some version of the effects principle has been adopted by most major powers around the world . . . .").

120. *See* Michaels, *supra* note 103, at 541.

121. *See* RAUSTIALA, *supra* note 84 at 7, 224, 230 (emphasizing the incentives to display an extraterritorial approach and the advantages of such an approach); Meyer, *supra* note 31, at 112 (emphasizing strategic advantages to the United States from extraterritoriality).

122. *See*, e.g., Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, 75 L. & CONTEMP. PROBS. 161, 163 (2012) (noting that the *Morrison* rule applied not only to "foreign cubed" cases but also "across the board, including in cases in which the U.S. regulatory interest is significantly stronger (such as those involving the foreign transactions of U.S. rather than foreign investors), or the conflict with other regimes significantly milder (such as those involving individual rather than class claims"); Donald C. Langevoort, Schoenbaum *Revisited: Limiting the Scope of Antifraud Protection in an Internationalized Securities Marketplace*, 55 L. & CONTEMP. PROBS. 241, 245 (1992) (highlighting the importance of protecting against the effects of global securities transactions in the U.S., and describing this rationale as a "most compelling" justification for the extra-territorial application of U.S. regulation).

123. *See* Parrish, *supra* note 112, at 1458-59 & note 13 (noting that the effects test was not only perceived as modern by commentators, but that it has also gained the support of several other jurisdictions, which began to apply it as well). Other jurisdictions that have adopted some version of the extra-territoriality rule include Germany, France, Australia, and Denmark. *See* Jürgen Basedow & Stefan L. Pankoke, *General*

imposed narrow test.[124] Why?[125] Conventional explanations focus on the issue of certainty and predictability, and most scholars have argued that by receding to a narrow territoriality, the United States responded to the complaints of exaggerated extraterritoriality raised by other jurisdictions.[126]

II. The Case of the Derivative Action

This portion of the discussion attempts to implement in the context of the derivative action mechanism the insights gathered with regard to the conflict-of-laws doctrines discussed in Part I. The goal is to develop a framework for deciding which law—forum law or the relevant foreign law (*lex incorporationis*[127])—should regulate the terms and conditions under which a derivative action is to be filed before courts of the forum on behalf of a foreign corporation. To emphasize my arguments, I shall employ as a stylized example a case demonstrating a conflict-of-laws between a local law that allows a derivative action and a foreign law that does not.[128]

A. Why *Lex Incorporationis* Should Not Always Be Applied

One could argue that in cases in which a derivative action is filed before the forum court on behalf of a foreign corporation, the terms of the derivative action mechanism, as well as the basic entitlement to file this unique civil lawsuit (as opposed to the cause-of-action upon which the suit is brought[129]), should be exclusively regulated by the *lex incorporationis*—i.e., the foreign law—and not by the law of the forum.

1. *The Incorporation Bargain*

The most important reason, one could argue, is simple: it is all about

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Report, *in* LIMITS AND CONTROL OF COMPETITION WITH A VIEW TO INTERNATIONAL HARMONIZATION 1, 27-29 (Jürgen Basedow, ed., 2002).

124. For a reading of another Supreme Court decision that echoes a narrow territorial approach, see Michaels, *supra* note 103, at 536, 538-41 (analyzing F. Hoffmann-La Roche Ltd. v. Empagran S.A., 542 U.S. 155 (2004)).

125. For another line of reasoning, of a realist nature, see Larry Kramer, *Vestiges of Beale: Extraterritorial Application of American Law*, 1991 SUP. CT. REV. 179, 202 (1991) (arguing that the presumption against extraterritoriality masks judicial resentment of congressional regulation).

126. *See, e.g.*, Stephen J. Choi & Linda J. Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465, 467 (2009). *See also* Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 624 (S.D.N.Y. 2010) (applauding the Supreme Court's decision in this regard). This rationale, which was also endorsed by several foreign governments that submitted amicus briefs to the court, highlights the possible negative effect that unpredictability may have on foreign investors' activities and investments in the United States because the exposure to liability has become uncertain.

127. *See supra* note 16 (for reasons of convenience ignoring the question of applying *lex incorporationis* versus applying the law of the real seat).

128. *See supra* note 12 (providing relevant examples).

129. While the cause of action may also be regulated by the *lex incorporationis*, and often is, in fact, regulated in such manner, the discussion of this choice-of-law question is beyond the scope of the current paper.

enforcing contracts and keeping promises.[130] When deciding to incorporate abroad, rather than in the forum state (although the latter may, in fact, be the corporate entity's primary place of business), investors take upon themselves an entire set of contractual obligations.[131] It is a contract woven through the integration and interaction between the corporate entity's charter and bylaws and the foreign laws in the state of incorporation. In fact, in as much as the corporate entity's bylaws do not specifically address a particular issue—including the entitlement to commence a derivative action—the law of the state of incorporation becomes the source of relevant default terms to be included in any contract. The investors choosing to incorporate in a particular foreign jurisdiction can be assumed to have performed so after "shopping around," comparing the various laws of several jurisdictions to find their best fit.[132] Obviously, promises should be kept and contracts should be enforced. Thus, if the contract undertaken by the corporate entity's shareholders included an agreement that derivative action shall not be available as a remedy—even if such a covenant was included only as a default term supplied by the law of the state of incorporation—this agreement should be upheld. Indeed, had it been the other way around, and the foreign law of incorporation would have extended a relevant entitlement or protection to these shareholders (even in the context of the derivative action mechanism), these investors would no doubt argue for application of the foreign corpus of laws and not for the application of the law of the forum.

To complete the circle and maintain cohesion with conflict-of-laws doctrine, note that this contractual argument is a policy consideration that would serve to influence the choice-of-law decision, notwithstanding the conflict-of-laws methodology adopted by the relevant forum. In jurisdictions that adhere to the "traditional" choice-of-law methodology (which relies on characterization, discovering the related connecting factor, and later localizing it to derive the applicable law), this policy consideration would serve to opt for *lex incorporationis* as the connecting factor. Conversely, in jurisdictions that adhere to the modern choice-of-law methodology (such as the theories of the Most Significant Relationship or Governmental Interest Analysis), a policy consideration would be employed ad hoc to influence the choice of applicable law within the confines of these theories.[133]

Nevertheless, it should be noted that the contractual argument cannot justify application of *lex incorporationis* to all cases. Indeed, the contractual argument is exposed to two lines of criticism.

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130. *See* also Ehud Kamar, *Catch Me If You Can*, GLOBES (Sept. 6, 2011) (articulating this rationale).

131. *Cf.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15-22 (1991).

132. *See* Kersting, *supra* note 11, at 10-11.

133. *See generally* CURRIE ET AL., *supra* note 4 (discussing and comparing the traditional and modern methodologies).

The first critique addresses the nature of consent to the contract in question. While it is well accepted that agreements should usually be enforced,[134] in the corporate context a relevant concern is the existence of informed consent. When investors decide to incorporate in a certain jurisdiction, one could correctly note that they agree to undertake the complete package of obligations accompanying the foreign incorporation, some features of which may prove to have a wealth-decreasing effect in the future. As long as investors are aware of the pertinent risks and are, nonetheless, willing to accept these risks, they should be bound to their contract once any risk materializes. However, if investors are unaware of all the terms of the contract, the contractual argument becomes significantly less convincing. The problem with the contractual package to which investors commit as they execute the act of foreign incorporation is that there is serious doubt whether investors are in fact fully aware of the various legal nuances included in the package.[135] Moreover, unlike the package deriving from a local incorporation, with regard to which local investors often have an accumulated body of knowledge and past experience, the set of contractual terms deriving from a foreign incorporation is sometimes a mystery for certain investors. In particular, such investor ignorance is likely with regard to contractual terms, the relevance of which is variable, in the sense that any particular set of terms may or may not become important in the future. In short, when incorporating abroad, investors may be interested in and aware of immediately pending tax benefits but unaware of the terms for filing a derivative action should the corporation be wronged at some point in the future (if at all).[136]

The second criticism concerns the scope of party autonomy. While the existence of a contractual agreement between the relevant parties regarding the choice of applicable law is by itself a powerful argument justifying the enforcement of such an agreement, one could harbor doubt as to whether the parties were originally entitled to agree on the matter. Indeed, when parties appear before the forum court (and one of them is) arguing in favor of a contractual agreement that implicates the choice-of-law inquiry conducted by the court, caution is advised. It is well known that not all forms and contexts of choice-of-law are open to private parties to contract about.[137] Indeed, several choice-of-law contexts are highly regulated and may implicate an important public interest such that the parties are not

134. *See* Michael T. Janik & Margaret C. Rhodes, *A Review of Recent Decisions of the United States Court of Appeals for the Federal Circuit*: Gould, Inc. v. United States: *Contractor Claims for Relief Under Illegal Contracts with the Government*, 45 AM. U.L. REV. 1949, 1950 (1996).

135. *See generally* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE 2-3, 38-39 (2011) (explaining the legal complexities and forum-selection intricacies of derivative action cases).

136. *See id.* at 207-08, 214-15 (detailing the numerous possibilities of considerations made in choice of law standards as these standards apply to derivative actions).

137. *See, e.g.*, PETER NYGH, AUTONOMY IN INTERNATIONAL CONTRACTS 46, 53-54, 57, 59 (1999); Giesela Rühl, *Party Autonomy in the Private International Law of Contracts: Transatlantic Convergence and Economic Efficiency*, *in* CONFLICT OF LAWS IN A GLOBALIZED WORLD 153, 160 (Eckart Gottschalk et al. eds., 2007); Mo Zhang, *Party Autonomy and*

allowed to contract around the forum's preferred choice-of-law. In the United States, for example, contexts in which the forum has a significant public interest in regulating the matter—such as contexts involving market failures that implicate markets in the forum's jurisdiction—are usually not characterized by the forum as "internal affairs" of the corporate entity and are, therefore, removed from the sphere of application of the *lex incorporationis*.[138]

Moreover, it has already been argued, particularly in the area of corporate law, that allowing investors to evade the law with the greatest interest in regulating their behavior, or the law with which they have the most important contacts, by straightforwardly applying *lex incorporationis* to regulate their "internal affairs" is illegitimate both in terms of efficiency and of democracy.[139] Such illegitimacy emerges due to the ease with which corporate entities can incorporate in any foreign jurisdiction in combination with the rather wide array of issues that come under the definition of "internal affairs," including many issues that affect various stakeholders.[140]

Consider a stylized example. While forum law entertains the option to engage in a derivative action, *lex incorporationis* rules out that form of action altogether. However, suppose the corporate entity in question is one that had incorporated in the foreign jurisdiction but all relevant parties, including its shareholders and officers, are residents of the forum. Suppose further that the forum is interested in deterring officers, directors, and controlling shareholders from employing corporate mechanisms and vehicles (including foreign ones) to prejudice investors unfairly (by breaching fiduciary duties owed to the corporate entity) or stakeholders and particularly weak stakeholders (by employing disputed corporate practices, such as maximizing only shareholders' profits instead of stakeholders' welfare or generally maximizing the corporate entity's profits). The forum may be interested in maintaining the regulation of such defendants outside the scope of party autonomy, excluding the possibility that these defendants would be able to contract their way out of being sued. The forum may also be interested in doing so not only for the purpose of protecting stakeholders but simply to prevent a foreign jurisdiction from reaching beyond its borders to influence activities inside the forum jurisdiction because residents of the forum cannot politically influence the rules of corporate

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Beyond: An International Perspective of Contractual Choice of Law, 20 EMORY INT'L L. REV. 511, 524 (2006).

138. *See* DEMOTT, *supra* note 6, at 210; *see, e.g.*, Friese v. Superior Court, 134 Cal. App. 4th 693, 702, 709 (Cal. Ct. App. 2005) (stating that a specific dispute regarding a prohibition on insider trading is not to be characterized as "internal affairs" of a public corporation).

139. *See* Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 LAW & CONTEMP. PROBS. 135, 135-36 (2004) (making this argument against the backdrop of the modern American choice-of-law methodology).

140. *See id.* at 136-37.

law enacted by the relevant foreign jurisdiction.[141] In corporate entities in which agency problems severely trump any hope of the corporate entity formally fighting on its own against its insiders, the only way for the forum to accomplish the goal of deterrence, or minority shareholder or stakeholders' protection, would be to apply forum law instead of *lex incorporationis* to the specific dispute concerning the entitlement to file a derivative action. Otherwise, the goals of deterrence and protecting weakened investors and stakeholders cannot be accomplished. To be sure, allowing *lex incorporationis* to regulate the derivative action mechanism amounts to extending potential defendants with immunity or insurance even for acts that constitute a breach of fiduciary duties (or other non-insurable or non-indemnifiable duties).

Furthermore, recall that in some jurisdictions creditors, including involuntary creditors, can also file a derivative action.[142] In these jurisdictions, applying *lex incorporationis* to regulate the derivative action mechanism and the very entitlement to initiate derivative action severely damages the protection afforded by the forum to such corporate stakeholders, who may, in fact, become involved with the corporate entity involuntarily. In those cases in which the corporate entity's main activity is within the forum jurisdiction and its incorporation abroad was purely for tax purposes, for example, applying *lex incorporationis* to decide if a derivative mechanism can be filed at all is tantamount to securing a process of externalization by corporate insiders of the costs of their activity on creditors. In those jurisdictions, incorporating abroad can become a relatively comfortable tool employed by corporate insiders to opt out of local regulation.

Finally, even in the absence of creditors as potential plaintiffs in derivative actions, in the context of party autonomy, the forum is certainly allowed to doubt the justice of allowing corporate insiders to evade liability by pushing investors to incorporate in a jurisdiction with an inferior derivative action mechanism—inferior for plaintiffs, that is—to the mechanism employed by local law. The reason is the possible initiation of a race to the bottom.[143] Indeed, in an ever-globalized world, opportunistic jurisdictions can be easily found to offer foreign investors protections and benefits that they cannot secure in their jurisdiction of origin. A unique form of race would be engendered as foreign jurisdictions offer packages of investor incentives (e.g., tax incentives) coupled with inferior investor protection (e.g., lack of a derivative action mechanism). Such a package can attract

141. *See id.* at 137 (arguing that Delaware reaches beyond its borders in such a manner).

142. *See supra* note 5 and accompanying text.

143. *Cf., e.g.*, David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423 (1991) (discussing the problem in general in the context of the European Union); Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J. L. ECON. & ORG. 79, 80 (2011) (discussing the American race-to-the-bottom critique, which maintains that "state competition produces a body of law that inefficiently benefits managers at the expense of shareholders"); Kersting, *supra* note 11, at 42 n.214 (citing European sources).

investors to incorporate while protecting those who assume insider positions within the corporate entity. In fact, for a jurisdiction offering inferior investor protection against insiders' malfeasance (e.g., in the form of immunity from derivate action), there appears to be no real cost associated with such actions. Offering such a benefit for unscrupulous insiders would be attractive for purposes of luring investors from the forum to incorporate in the foreign host's jurisdiction. Thus, these investors from the forum's territory will pay corporate taxes to increase the foreign jurisdiction's budget, while the costs of insiders' malfeasance would be solely borne by those investors in the forum, due to the location of the corporate entity's primary place of business.[144] Indeed, the phenomenon of pseudo-foreign corporate entities is well known: that is, local corporate entities whose only foreign connection is the act of incorporating in a foreign jurisdiction.[145] Even if one were to claim that investors in pseudo-foreign corporate entities are hardly victims of any externalization because they agree to the terms of the corporate contract (which might, for example, exclude the possibility of employing a derivative action mechanism), and even if one were to ignore a possible externalization effect upon corporate stakeholders who have not and cannot consent to the incorporation abroad, the forum may be interested not in the welfare of these investors but rather in securing a source of income for itself. In other words, the reason for attempting to block competition from other jurisdictions may be a public interest in having investors "stay at home" and pay taxes in the forum rather than incorporate abroad.

2. *Derivative Action as a Remedy*

Lex incorporationis may be excluded for another reason: an institutional one. The specific dispute, with regard to which a choice-of-law decision is required, concerns the terms for filing a derivative action, not the cause of action itself. In other words, the choice-of-law question requires the court to choose a mechanism to manage the filing of a derivative action. One could expect that the forum court would resist any attempt to impose upon it a foreign mechanism. For example, one could argue that the substance-procedure doctrine should be employed to generate a decision that would rule out foreign law in this context and would adhere solely to the law of the forum, at least for the purpose of protecting the local court from being unduly burdened and inconvenienced by the need to apply the foreign law.[146] To illustrate the possible power of this argu-

144. *Cf.* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 17-18 (2006) (describing a situation where Delaware's corporate-friendly bankruptcy proceedings forced other states to change their bankruptcy proceedings as well in order to compete).

145. *See* Elvin R. Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137, 137 (1955) (defining such a corporate entity as a local entity, the business and personnel of which are predominantly associated with the forum jurisdiction while the entity itself is incorporated in a foreign jurisdiction).

146. *See supra* Part I.B.2 (discussing this rationale in the context of the substance-procedure distinction).

ment, consider a slight modification to our working example. Suppose the specific dispute involves an entitlement to file a class action lawsuit rather than a derivative action lawsuit. In such a case, the forum should at least fear the possibility of applying a foreign law that would exclude class actions because then the forum may instead be burdened by a large number of individual lawsuits that are filed due to the absence of a class action path.

Should a similar burdening consideration be employed with regard to the derivative action? The answer appears to be yes.

One needs to understand that the situation that will generate this question has two variations. Indeed, the burdening argument may be evoked not only when the law of the forum is more lenient for plaintiffs than the foreign *lex incorporationis*. Had it been the other way around, with *lex incorporationis* allowing a derivative action when such is disallowed by the *lex fori*, the plaintiff would have argued for the application of *lex incorporationis* (assuming that the plaintiff could not file the action in that foreign jurisdiction to begin with). In such a case, however, defendants would probably argue for application of the law of the forum and cite as a reason the expected imposition upon the forum court of an unfamiliar derivative action mechanism and perhaps even of allowing a derivative action when such litigation patterns do not exist in the forum.

However, there appears to be an asymmetry created between plaintiffs and defendants because each calls for the application of *lex fori* instead of *lex incorporationis*. In the extreme case of a foreign law that completely excludes the possibility of filing a derivative action, applying such a law is not expected to engender any imposition upon the court system of the forum. The reason is that unlike a class action mechanism, which is a horizontal litigation mechanism substituting for a set of personal claims, the derivative action is a vertical mechanism. Specifically, the derivative action does not substitute a bulk of personal claims but rather expands the group of plaintiffs that are entitled to litigate a particular cause of action that belongs to the corporate entity. It is true that the derivative action mechanism does add one more type of plaintiff (either a shareholder, or—as in some jurisdictions—even a creditor) to the list of possible plaintiffs. However, in the opposite extreme case in which the *lex fori* is the one that excludes a derivative action while *lex incorporationis* entertains that option, applying *lex incorporationis* may, in fact, burden the courts in the forum jurisdiction because they would be required to adjudicate questions with which they are unfamiliar, such as when a particular plaintiff is entitled to file a derivative action and on what terms she may file.

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To conclude, the decision with regard to the choice of a derivative action mechanism (a choice which is the result of choosing the law applicable to a specific dispute concerning any of the terms for commencing a derivative action) is not one-dimensional, as some might argue. Indeed, one suggestion is to refrain from a general acceptance of the proposition

that the choice of investors to incorporate abroad should unequivocally subject them to the application of the law of incorporation on all matters concerning intra-firm relations. The decision of which law to apply is more nuanced.

B. The Correct Framing

Because the choice of a law to regulate the derivative action mechanism is not an obvious one, a preliminary question that must be addressed concerns the appropriate legal framework within which the pertinent policy discussion should take place. In other words, the question is which conflict-of-laws doctrine should serve as a platform or a focal point for resolving the choice-of-law problem discussed in this paper. Answering this question is necessary because it may help us understand and perhaps even shape the dynamics of judicial decision-making when such a choice-of-law question presents itself.

From a practical standpoint, because the choice-of-law rule with regard to "internal affairs" of the corporation points to applying *lex incorporationis*, one can expect that even if the court would be inclined to characterize the specific dispute concerning the derivative action mechanism as a matter of "internal affairs," the party opposing the result of applying a foreign *lex incorporationis* would no doubt evoke one of the relevant "escape hatches"—either the public policy doctrine or the substance-procedure distinction. A third doctrine that may be invoked to serve as the framework for discussion, this time by a party favoring application of the *lex incorporationis*, is the presumption against extraterritoriality (when the relevant local statute is silent on its application to foreign corporations) because the presumption would effectively serve to limit the extraterritorial application of a silent-on-its-transnational-reach forum law.

One could argue that these three doctrines are not meant to replace one another and each has its own fundamental rationale.[147] However, because the choice-of-law decision is relatively policy-oriented and because policy considerations can actually be invoked in any context, it appears reasonable to assume that the court would focus on one of these doctrines to resolve the choice-of-law query.[148] Notwithstanding, one may wonder which doctrine, if any, fits best that task of adjudicating the choice-of-law question.

From a choice-of-law methodology viewpoint, I argue that the public policy doctrine appears to be the better platform to resolve disputes concerning the applicability of a local derivative action mechanism when such lawsuits are filed on behalf of foreign corporations.

The substance-procedure doctrine appears de-facto to have excluded itself from being chosen as the relevant framework. In jurisdictions that

147. *See supra* Part I (discussing these rationales).

148. The discussion will proceed along the lines of traditional choice-of-law methodology because in the context of a modern choice-of-law methodology, courts are already well-prepared to conduct a policy-oriented choice-of-law inquiry and actually are in less need of "escape devices" to pursue substantive policies.

follow the traditional choice-of-law methodology, which is based on neutrality—i.e., the forum strongly attempts to refrain from any inclination towards either the forum law or the foreign law—the substance-procedure doctrine has been demonstrated to be quite problematic. Part I of this paper revealed that while the distinction between substance and procedure cannot be executed in an *a priori* manner without a rationale to drive it, as the line between substance and procedure is very indistinct and from a purely jurisprudential viewpoint may not even exist, the substance-procedure doctrine cannot handle just any rationale and actually must be carefully harnessed. Indeed, once lawmakers attempt to employ the substance-procedure distinction to promote any policy consideration which comes to their mind—as seems to have happened in certain jurisdictions[149]—the road becomes much shorter to making the substance-procedure distinction a "back door" through which the law of the forum would be excessively applied.

The Presumption against Extraterritoriality also does not appear to be a very good platform when applied to the specific choice-of-law question presented here. The reason lies in this doctrine's relatively rigid and arbitrary nature. The Presumption against Extraterritoriality works well when, on the one hand, statutes are silent on their application to transnational cases, and on the other hand, local regulation has a tendency to spread excessively to transnational cases. However, in the context of the derivative action mechanism, there appears to be no specific problem of excessive extraterritoriality, due to the rather clear-cut choice-of-law rule that applies *lex incorporationis*—which is a foreign law for foreign corporations—to regulate the "internal affairs" of foreign-incorporated entities. Furthermore, when the forum has a derivative mechanism legislation that specifically articulates its applicability in the transnational context, the presumption against extraterritoriality becomes irrelevant.

In contrast, the public policy doctrine serves as a context in which the forum can "put his foot down" and express intolerance for an applicable but offensive foreign law. This doctrine is, therefore, an exception to the rule. More importantly, the public policy doctrine is shaped and litigated in practice as an exception because the question judges ask themselves when employing it is whether application of the foreign law is sufficiently unbearable that the doctrine must be invoked to apply the law of the forum instead of the applicable foreign law. Even if the judge is only mildly cautious, she would be inclined to refrain from employing the public policy doctrine to apply the law of the forum instead of the foreign law.

Moreover, as was described in Part I, in recent years the doctrine's open texture is beginning to take form along certain predictable vectors, such as proximity, relativity and seriousness of breach.[150] The adoption of these vectors contains the doctrine and streamlines it so that it performs in

149. *See supra* note 66 and the accompanying text (discussing U.K. and Israeli law).
150. *See supra* note 73.

practice as an exception only, thereby allowing a more free application of foreign law.

How do these general developments in conflict-of-laws doctrine relate to the choice-of-law question as it is related to the derivative action mechanism in the case of a foreign corporation? The discussion thus far revealed that when the corporate entity in question is incorporated in a foreign jurisdiction, application of *lex incorporationis* to regulate the derivative action mechanism should still be the rule in many cases. Indeed, in certain cases, the forum would justifiably prefer to apply its own law over the *lex incorporationis* (only to regulate the derivative action mechanism, of course, not the cause-of-action against the defendants). Without a doubt, however, these cases are, and should be, only an exception. The public policy doctrine, with its built-in-exception mentality and evolving limiting vectors, fits perfectly as a platform to adjudicate this choice-of-law question.

C. The Irrelevance of Forum Shopping

Notwithstanding its precise doctrinal framework—whether it is the substance-procedure distinction, the public policy doctrine, or the presumption against extraterritoriality—the decision regarding choice of law regulating the derivative action mechanism should, nevertheless, be resolved in accordance with certain policy considerations. Most of these considerations have already been discussed.[151]

The most important policy consideration without a doubt focuses on giving investors—for better or worse—what they bargained for. This consideration will usually prevail and lead to the application of the foreign law of incorporation, even if, from the perspective of a potential plaintiff, the meaning completely denies her the option of filing a derivative action. However, this consideration may take a wholly different form if parties do not actually demonstrate consent, for example, if the plaintiffs are involuntary creditors or if the forum decides that the consent was not sufficiently informed according to a standard the forum believes appropriate.

Another important consideration would focus on coping with possible market failures created and felt at the forum as a result of applying the foreign law of incorporation to regulate the derivative action mechanism. The existence of such failures may direct the forum to refrain from applying the foreign law of incorporation and instead apply the law of the forum as a corrective measure.

However, what policy considerations should *not* be taken into account and should not influence the choice-of-law decision?

One notable and, importantly, irrelevant consideration is forum shopping. In the area of conflict-of-laws, forum shopping is an unwarranted

151. *See supra* Part II.A.

phenomenon.[152] Selfish plaintiffs who seek to take advantage of conducting litigation in a certain jurisdiction rather than in a more obvious and expected one manipulate the process, curtail efforts to minimize litigation costs, and disrupt attempts by jurisdictions to attract litigation.

However, the question is whether application of *lex incorporationis* should be included as a measure in the battle against forum shopping plaintiffs. The underlying rationale is to deter plaintiffs from forum shopping by making sure that the law that was originally intended to regulate their relationship with the defendants would "follow" them to whichever forum they choose.

Still, jurisdictional doctrines, mainly the *Forum Non Conveniens* doctrine, can discourage forum-shopping behavior.[153] Therefore, courts do not necessarily need to turn to the choice-of-law of process, which is already sufficiently complicated, to deter such behavior.

Moreover, forum shopping for some plaintiffs serves a purpose other than evading the substantive regulating law. These plaintiffs attempt to escape their home court when it is known for being pro-defendant, particularly with regard to either intangible aspects of the litigation (e.g., a court's reluctance to encourage, or even hostility toward, certain forms of lawsuits) or specific disputes that are traditionally known to be regulated by local law (e.g., standard of proof, attorneys' fees, or trial costs). For example, in Delaware the courts' inclination to harness attorneys' fees or police plaintiff behavior by imposing stricter pleading standards caused plaintiffs systematically to seek other venues in which to file derivative lawsuits.[154] For these plaintiffs, application of a foreign law is hardly a deterring measure, as long as they are allowed to proceed and adjudicate their claim before the forum.

Furthermore, in the context of corporate litigation, most lawsuits emerge against a contractual background. In other words, some form of contract—either a shareholder agreement or a corporate charter and bylaws—already binds the plaintiff and the defendant. Thus, one can expect that potential defendants in derivative actions would anticipate in advance the possibility of being hauled into a foreign forum and protect themselves by including in the relevant contract a forum selection clause.[155] Such a clause would accord exclusive jurisdiction to a court in the jurisdiction in which the corporate entity has incorporated (or any jurisdiction, for that matter) and resolve any pending problem of forum shopping.

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152. *See* ANDREW S. BELL, FORUM SHOPPING AND VENUE IN TRANSNATIONAL LITIGATION 18-20 (2003); MICHAEL MOUSA KARAYANNI, FORUM NON CONVENIENS IN THE MODERN AGE: A COMPARATIVE AND METHODOLOGICAL ANALYSIS OF ANGLO-AMERICAN LAW 17, 34 (2004).

153. *See, e.g.*, KARAYANNI, *supra* note 152.

154. *See, e.g.*, Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137, 143-44, 146 (2011) (discussing attempts by plaintiffs to flee Delaware for such reasons).

155. *See id.* at 141-42.

In short, the focus with regard to discouraging forum-shopping behavior should be on employing jurisdictional doctrines, rather than choice-of-law doctrines.

Conclusion

This Article takes a comparative approach to analyzing the manner in which a choice of a law to regulate derivative actions against foreign corporations should be made. The main theme was the rejection of an approach that considers the choice-of-law process to be a one-dimensional decision—mainly to enforce upon investors the law of the foreign state of incorporation, allegedly as part of the deal that they made when they became shareholders in such a corporation. Indeed, the choice-of-law decision is more complex. The Article explained why the relevant platform for discussions should be the public policy doctrine and discussed possible considerations to be taken into account in this context.