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BRENNAN LECTURE

THE REACH OF STATE CORPORATE LAW BEYOND STATE BORDERS: REFLECTIONS UPON FEDERALISM

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In this speech, delivered for the annual Justice William J. Brennan, Jr., Lecture on State Courts and Social Justice, the Honorable Jack B. Jacobs demonstrates that state corporate law sometimes acquires an extraterritorial reach. The federalist model of corporation law assumes that each state's law only reaches to that state's border, but reality has diverged from that model through state anti-takeover statutes, the internal affairs doctrine, and state "corporate outreach" statutes that impose internal governance requirements on companies incorporated in other states. Anti-takeover statutes are essentially grounded upon the internal affairs doctrine, which holds that such affairs are governed by a company's state of incorporation. But the corporate outreach statutes attempt to supersede the law of the state of incorporation, exposing companies to conflicting internal governance requirements. The Supreme Court could resolve this conflict by deeming the internal affairs doctrine either a choice-of-law rule or a rule of constitutional law. The former choice could lead to economic disruption, while the latter would increase interstate competition for incorporation business and sustain the current diversity of legal choices available to corporations.

INTRODUCTION

During their first year of law school, our students are taught some eternal verities. One of them is that the United States's federal system consists of fifty states, each governed only by its own law and

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not by the law of any other state. Overlying this state law tapestry is a structure of federal law that operates in its own distinct sphere. Someone from another planet viewing this structure for the first time might wonder how fifty separate jurisdictions can operate harmoniously without getting in each other's way. The answer, we would tell our extraterrestrial visitor, is geographical containment: Each state's law reaches only to that state's border, but no further. In theory, at least, that is how our federalist model is supposed to work. But as with much in life, the reality is more complex than the theory. This is particularly true in the case of corporate law because in that arena, state law will often acquire an extraterritorial reach that is at odds with the theory.

This topic is of more than academic interest. My subject—how the corporate law and governance rules of our states interact with each other in a federal system—bears importantly on the efficient operation of the American economy. In this current economic environment, this is a subject that concerns us all.

In this short Essay, I will cover three topics. First, I will develop the historical background behind the current model of how state corporate laws are supposed to interact. Next, I will discuss how reality has come to diverge from the model, through efforts to endow state corporate law with extraterritorial reach through anti-takeover statutes, the internal affairs doctrine, and corporate outreach statutes. Finally, I will attempt to answer the "so what?" question: What are the practical implications of this divergence, and where might those developments take us in the future?

I
Historical Development of the Model

As I said earlier, our corporate federalist model resembles a patchwork of fifty separate bodies of state corporate law, plus the corporate law of the District of Columbia, all overlaid by a separate body of federal law. By "corporate law," I mean state statutes and judicial decisions that regulate matters such as forming a corporation, the powers and duties of (and relationships among) officers and directors, the rights of stockholders, the corporate decisionmaking process, raising capital by issuing stock and other securities, corporate elections, corporate mergers, sales of assets, and the like. "Corporate law" must be distinguished from "commercial law," which is the body of rules that governs the corporation's *external* economic relationships with parties outside the corporate family, such as suppliers and customers.

A key characteristic of this corporate federalist model is that a state's corporate law governs only those corporations that are formed under that particular state's corporate law.[1] The main reason for this is historical. Until the twentieth century, all American corporate law was local. In fact, until the late nineteenth century, state corporate statutes did not even exist; to form a corporation in any state, a special act of that state's legislature was required.[2] This regime was problematic because it tethered economic expansion to access to the political system. In our political system, tradeoffs are often required to persuade a legislature to act. For nineteenth century entrepreneurs, those tradeoffs imposed delays and other costs that burdened the development of large private enterprise.

By the Industrial Revolution, our country had reached the stage of economic development where huge amounts of capital were needed to finance railroads, steel foundries, and other basic industries that would form our national economic infrastructure. Raising capital of that magnitude required creating incentives to invest significant sums of money in firms over which investors would have little or no control. A key incentive turned out to be a new, easily available business-entity form that limited the liability of investors and also enabled them to exit their investment easily and relatively cost-free by selling their interest to a different investor. That entity form was the publicly held stock corporation.[3]

By this point it also had become clear that requiring entrepreneurs to resort to the political process to form these new stock corporations was highly inefficient. Eventually the requirement that corporations be created by special legislative act was jettisoned, and in its place, the states adopted general corporation laws that allowed any citizen who followed the prescribed statutory rules to form a corporation privately.[4] Some states adopted general incorporation statutes quite early. New York, for example, adopted the first general incor-

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[1] *See, e.g.*, DEL. CODE ANN. tit. 8, § 101 (2001); MODEL BUS. CORP. ACT § 2.02(a) (2005).

[2] *See, e.g.*, Andrew G.T. Moore II, *A Brief History of Delaware and the Amendatory Process*, *in* 1 DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS H-1 (R. Franklin Balotti & Jesse A. Finkelstein eds., 3d ed. 2001); JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780–1970, at 15 (The Lawbook Exchange 2004) (1970) ("After independence the consistent practice was to create corporations by special statute.").

[3] *See, e.g.*, HURST, *supra* note 2, at 26 ("[T]he corporate form encouraged the muster or retention of resources by offering investors an assured frame of limited commitments . . . .").

[4] In Delaware, for example, the Constitution of 1897 provided that "[n]o corporation shall hereafter be created, amended, renewed or revived by special act, but only by or under general law . . . ." DEL. CONST., art. IX, § 1.

poration statute in 1811; Connecticut adopted its statute in 1837.[5] Other states followed similar trajectories, but later in the century. Delaware, a relative latecomer, adopted its first Delaware General Corporation Law in 1899.[6]

A second important feature of the late nineteenth century federalist model was that the reach of state corporate law was local—that is, each state's law stopped at the state boundary line. Again, the reasons were historical: Except for a few giant multistate operations such as Standard Oil, U.S. Steel, and the large railroad companies, most corporations chartered under the new state statutes—and their officers, directors, stockholders, and business operations—were located in a single state. Not surprisingly, any disputes involving these corporations' internal affairs were governed by local state corporate law, and the resolution of those disputes affected, by and large, only the local citizens of that state.

To summarize, under the model that developed during the nineteenth century, each state had its own separate body of corporate law that was hermetically and geographically separate from the corporate law of the other states. That model accurately described the reality: Except for federal antitrust legislation enacted in the late nineteenth and early twentieth centuries,[7] no law regulating corporations reached beyond state lines.

During the twentieth century, however, this model changed. In the 1930s, as we know, the New Deal added a second, overlying layer of newly enacted federal law to remedy dislocations caused by the failure or inability of state law to keep up with changes in our national economy. Before World War I, the investors in American capital markets were a relatively few persons of great wealth.[8] After the war, the United States witnessed an unprecedented growth of companies with multistate and often nationwide operations, which needed a larger investor pool to satisfy increased capital needs.[9] That, in turn, required soliciting capital investments from potential investors who

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[5] William T. Allen et al., Commentaries and Cases on the Law of Business Organization 88 (2d ed. 2007).

[6] 21 Del. Laws 445–503 (1899).

[7] Sherman Antitrust Act, ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1–7 (2006)), was passed in 1890. The Clayton Act, ch. 323, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. §§ 12–27, 29 U.S.C. §§ 52–53 (2006)), which amended the Sherman Act, was passed in 1914.

[8] Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. Legal Stud. 1, 5 (2001) (discussing dominance of "institutions and wealthy investors" rather than "retail investors" in United States securities markets before World War I).

[9] *See* Edwin Burk Cox, Trends in the Distribution of Stock Ownership 197 (1963) (hypothesizing that number of stockholders in United States grew from one million in 1900 to ten million by 1930).

lived in different states. By this point, corporate capital raising systematically crossed state lines; however, the law did not keep up with that change. That is, the law that regulated an increasingly national capital-raising activity—the corporate law of the state of incorporation and the local commercial law of whatever states the parties to the transaction were located—remained local.

In an increasingly national economy, this state-centered system of regulation proved woefully ineffective. State corporate and commercial law could not adequately regulate the manipulative and deceptive practices that often permeated securities transactions on national exchanges.[10] Because state corporate law could not prevent the abuses that ultimately resulted in the stock market crash of 1929 and the Great Depression, Congress adopted new federal legislation. That legislation included the Securities Act of 1933[11] and the Securities Exchange Act of 1934,[12] the latter of which created the U.S. Securities and Exchange Commission (SEC). These statutes marked the first, but by no means the last, major federalization of enterprise law that had been the exclusive regulatory domain of the states.

This new federal scheme fundamentally altered the original legal model. Whereas before 1934 there had been one layer of regulation, after 1934 there were two. Each layer operated independently of the other and with different functions. Although most internal affairs of corporations continued to be regulated by state law, now some were removed from the state law domain and transferred to the federal. The capital-raising mechanism and other interstate transactions in corporate securities became, and have continued to be, governed by a separate body of overriding and preemptive federal law.

Since the 1930s, that body of federal law has expanded, first to regulate changes of corporate control and later to cover other defined areas of corporate governance that were previously regulated by the states. For example, in its original form, the Exchange Act regulated the solicitation of proxies.[13] In 1968 that Act was amended to regulate the mechanics of conducting tender offers.[14] In 2002, it was amended

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[10] Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 42–50 (rev. ed. 1995) (discussing inability of state statutes to prevent securities fraud before Great Depression).

[11] Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

[12] Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2006)).

[13] 15 U.S.C. § 78n(a) (2006); 17 C.F.R. § 240.14a (2009).

[14] *See* 15 U.S.C. §§ 78m(d), 78n(d)–(f) (2006); 17 C.F.R. §§ 240.13d-1 to -102, 240.14d-1 to -103, 240.14e-1 to -6 (2009).

by the Sarbanes-Oxley Act,[15] which further displaced state corporate governance law in several discrete areas. And today in 2009, the new federal economic stimulus legislation has federalized other aspects of the internal governance of corporations that receive federal "bailout" funds. These include regulating the form and amount of executive compensation and bonuses and (in some cases) mandating a so-called "say on pay" advisory shareholder vote to approve certain executive compensation awards.[16]

I pause here to emphasize that my purpose is not to sound alarms about creeping federalization or to argue about whether that trend is good or bad. That is an entirely separate debate for another day. Our system of state corporate law regulation remains alive and well. I mention the federal law expansion only to complete my description of how our federalist corporate law model evolved historically.

I now turn to the second topic, which is how the corporate federalist model and the reality came to diverge over the past seventy years. In metaphorical terms, the question is how, in defiance of the theory of federalism, it became possible for one state's corporate law to cross over that state's boundary line and, in unforeseen ways, influence business activity that other states arguably had an interest in regulating.

II
The Model and the Reality Diverge

This divergence between the model and reality has taken three quite different forms. Of these, the first form has been declared legally invalid; the second has been declared legally valid; and the third has fallen somewhere in between. The first form of divergence resulted from what some refer to as the "first generation" of anti-takeover statutes; the second resulted from the widespread application of the internal affairs doctrine, which for generations has been a central feature of American corporate law; and the third resulted from the so-called "corporate outreach" statutes, which are exemplified by legislation adopted in California and New York.

15 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). For a general discussion of the impact of the Sarbanes-Oxley Act, see Symposium, *Corporate Governance Five Years After Sarbanes-Oxley: Is There Real Change?*, 52 N.Y.L. Sch. L. Rev. 475 (2007–08).

16 American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, Div. B, Tit. VII, § 7001, 123 Stat. 115, 516–20 (amending 12 U.S.C. § 5221) (limiting executive compensation).

A. Anti-takeover Statutes

I start with the anti-takeover statutes, which were a response by some state legislatures to the wave of hostile takeover bids that began in the 1960s. Many observers at the time felt that the hostile takeover by a bidder of a target company was generally good for the target company's shareholders because a takeover offered them a large premium over market price for their shares.[17] It was also believed that these takeovers often reduced industry-wide inefficiencies and thereby benefited the overall economy.[18] But with these benefits, there were costs: Hostile takeovers often were detrimental to the local communities in which target companies or their major facilities were located. They frequently resulted in the closure or relocation of those facilities, the loss of local jobs, and the loss of the revenues those jobs generated for the local community.[19]

In response, and at the urging of local managements and governments, thirty-seven state legislatures adopted so-called "first generation" anti-takeover statutes beginning in 1968.[20] Those statutes imposed procedural and substantive requirements for hostile takeover bids for local firms that were intended to—and did—create significant obstacles to the hostile bid's success.

The most graphic example is the statute that Illinois adopted in 1979.[21] That statute had a very broad sweep. It applied to takeover offers not only for target companies incorporated in Illinois but also for any non-Illinois target corporation (1) that had its principal executive offices in Illinois; or (2) of which ten percent of the securities subject to the offer were owned by shareholders located in Illinois; or (3) where at least ten percent of the corporation's stated capital and paid-in surplus were represented in Illinois. The statute required a bidder to notify the target company and the Illinois Secretary of State twenty days before the bidder's tender offer became effective. The

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17 *See, e.g.*, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965) ("[T]he potential return from the successful take-over and revitalization of a poorly run company can be enormous.").

18 *E.g.*, *id.* ("Only the take-over scheme provides some assurance of competitive efficiency among corporate managers . . . .").

19 *See, e.g.*, Emanuel Celler, Chairman, U.S. House Judiciary Comm., Conglomerate Merger Investigations, Remarks Before the Seventeenth Annual Antitrust Spring Meeting: Antitrust Report from Official Washington (Mar. 26, 1969), *in* 38 ANTITRUST L.J. 184, 184–85 (1969) (decrying tactics and effects of 1960s mergers).

20 WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS 471 (2d ed. 2007) (citing Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 234 (1985)).

21 Illinois Business Take-Over Act, Pub. Act No. 80-1421, 1978 Ill. Laws 1581 (codified at Ill. Rev. Stat., ch. 121 1/2, ¶ 137.51–.70 (1979)), *invalidated by* Edgar v. MITE Corp., 457 U.S. 624. 643 (1982).

Secretary of State could delay the tender offer by holding a hearing on its fairness. The statute required the Secretary to hold a hearing if requested by shareholders owning ten percent of the securities subject to the offer. Finally, the Secretary was empowered to enjoin an offer on certain specified grounds, including that the offer was substantively unfair.[22]

The Illinois statute was a poster-child example of one state reaching out across its own boundaries and unavoidably affecting the interests of citizens and businesses that had no relationship with Illinois. Although the statute's purpose was to protect local interests, its effect extended far beyond Illinois's boundaries. The statute regulated transactions that were interstate—indeed, national—in their scope. That is, its reach extended to foreign corporations that had minimal or no relationship to Illinois. For example, the statute regulated tender offers made to shareholders who were residents of states other than Illinois, by offerors that were usually not Illinois corporations, and for target companies that had no significant ties to Illinois. Because of the statute's breadth, it was inevitable that its constitutionality would be challenged.

That happened in 1979, when MITE Corporation, a Delaware corporation, made a hostile bid for an Illinois corporation called Chicago Rivet & Machine Company. MITE filed a lawsuit in federal court, claiming that the Illinois statute violated both the dormant Commerce Clause and the Supremacy Clause of the United States Constitution. The case ultimately reached the United States Supreme Court, which in a noteworthy 1982 decision invalidated the statute.[23] The Supreme Court held that Illinois had "no legitimate interest in protecting nonresident shareholders"[24] or in "regulating the internal affairs of foreign corporations."[25] Moreover, the statute offered to Illinois shareholders only "speculative"[26] protection, whose benefits were outweighed by the risk that the offer would fail due to defensive tactics by incumbent management. For these reasons, the Court concluded, the Illinois statute violated the Commerce Clause.

If *MITE* were viewed in a vacuum, one could argue that it represented a strong judicial endorsement of the principle that a state's corporate law cannot reach beyond its own borders. But any such argument would overstate the matter. Yes, the Illinois statute was a clear instance of one state overreaching to regulate matters and par-

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22 *Id.*
23 *MITE*, 457 U.S. 624, 643.
24 *Id.* at 644.
25 *Id.* at 646.
26 *Id.* at 645.

ties as to which that state had no legitimate interest. And yes, *MITE* reaffirmed that a state's ability to regulate corporate conduct beyond its borders is limited by the Constitution. Even so, it was believed—and the Supreme Court later confirmed—that a more narrowly drawn statute would pass constitutional muster.

In response to *MITE*, the legislatures of several states went back to the drawing board and adopted the so-called "second generation" statutes, a different form of anti-takeover statute with a more limited reach. These statutes regulated only target companies that were incorporated in their respective states. Moreover, and importantly, the manner of regulation was carefully crafted to fit within the parameters of the well-established internal affairs doctrine.

The internal affairs doctrine is a judge-made choice-of-law rule which mandates that disputes regarding "internal affairs"—"those matters which are peculiar to the relationships among or between the corporation and its . . . directors, officers and shareholders"[27]—are governed by the laws of the state of incorporation.[28] Illustrative examples of internal affairs include: the mechanics of incorporating, the election or appointment of officers and directors, the adoption of by-laws, the issuance of shares and bonds, the holding of directors' and shareholders' meetings, voting, the right to examine corporate records, corporate charter and by-law amendments, mergers, reorganizations, the reclassification of shares, the declaration and payment of dividends, and stock repurchases and redemptions.[29]

Although there were several variations on the second generation statutes, for our purposes I need discuss only one—the so-called "control share acquisition" statutes, which provide that if a bidder has acquired a certain percentage of the target company's voting power (for example, 20% to 33 1/3%, or 33 1/3% to 50%, or over 50%), the bidder cannot vote the acquired shares unless the target company shareholders first approve granting voting rights to those shares. The critical feature of those statutes is that they gave target company shareholders the right to vote on a proposed acquisition of large blocks of target company shares that, if approved, could result in a

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27 McDermott Inc. v. Lewis, 531 A.2d 206, 214–15 (Del. 1987).

28 *Id.*; *see generally* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1112–13 (Del. 2005) (noting that in all but rarest circumstances, federal constitutional principles require use of internal affairs doctrine); Draper v. Gardner Defined Plan Trust, 625 A.2d 859, 865–66 (Del. 1993) (quoting McDermott Inc., 531 A.2d at 214–18) (explaining application of internal affairs doctrine); Restatement (Second) of Conflict of Laws § 302 & cmt. a (1971); Note, *The Internal Affairs Doctrine*: *Theoretical Justifications and Tentative Explanations for Its Continued Primacy*, 115 Harv. L. Rev. 1480 (2002) [hereinafter *Continued Primacy*] (discussing justifications for internal affairs doctrine).

29 Restatement (Second) of Conflict of Laws § 302 cmt. a.

change of control.[30] In effect, the statutorily required vote was an opportunity for target company management to persuade shareholders to reject a potential offer that management believed would be inadequate or otherwise undesirable. That mandatory vote gave management leverage and deterred hostile bids because if the shareholders did not authorize the bidder to vote the shares being acquired, the bid would not go forward. A bidder's objective is to acquire the whole company, which means that the bidder must obtain enough voting power to approve a second-step merger. But even so, many predicted that, unlike the first-generation Illinois statute, the control share acquisition statutes would be found constitutional because they regulated only matters involving the internal affairs of a corporation chartered by the state.

Those predictions turned out to be correct. In a second test case, decided five years after *MITE*, the United States Supreme Court upheld the constitutionality of the Indiana takeover statute[31] in *CTS Corp. v. Dynamics Corp. of America*.[32] The Indiana statute was modeled after the control acquisition statutes I have just described, except that the shareholders of the target vote on whether or not the bidder can acquire any shares at all, rather than whether the shares, once acquired, would be permitted to vote.[33] The Supreme Court held that the Indiana statute did not violate the Commerce Clause because it applied only to Indiana target corporations and represented an exercise of Indiana's legitimate power to "regulate domestic corporations, including the authority to define the voting rights of shareholders."[34]

The lesson taught here is that a state anti-takeover statute, if drawn narrowly enough, can have legitimate extraterritorial effect. The Indiana statute was held valid because it applied only to target companies incorporated in Indiana and was limited to requiring that target shareholders approve the bid before it could go forward. But even thus limited, it is now established that Indiana—or any other state—can now lawfully regulate an offer made by a non-Indiana corporation to the shareholders of an Indiana corporation, even if those shareholders live in states other than Indiana.

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[30] For discussion of control share acquisition statutes, see, for example, Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 115–16 (1987); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1827 (2002).

[31] IND. CODE § 23-1-42-1 to -11 (2009).

[32] 481 U.S. 69 (1987).

[33] *Id.* at 73–74 (citing IND. CODE ANN. § 23-1-42-9(a)–(b)).

[34] *Id*. at 89 (citing RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304 (1971)).

This validated form of anti-takeover statute was essentially both a codification and a specialized application of the common-law internal affairs doctrine. That brings me to the second—and the most comprehensive—method by which a state's corporation law may acquire legitimate extraterritorial reach: the internal affairs doctrine itself.

B. The Internal Affairs Doctrine

In terms of extraterritorial reach, the internal affairs doctrine is far more comprehensive than the anti-takeover statutes because it is not limited to takeovers. The doctrine applies broadly to "the entire gamut of internal corporate affairs."[35] With few exceptions, both state and federal courts have consistently applied the law of the state of incorporation to that broad range of activity.[36]

Extraterritoriality is an unavoidable consequence of the internal affairs doctrine. As an example, imagine a company that is incorporated in Iowa. A lawsuit involving that corporation's internal affairs (say, a breach of fiduciary duty action) is filed in a New York court.[37] In that lawsuit, the New York court will apply the internal affairs doctrine and decide the case under Iowa corporate law, even if the director-defendants all live in Illinois, or the plaintiff shareholder lives in Wisconsin, or both. Or, imagine the opposite case—the lawsuit is filed in Iowa but involves the internal affairs of a New York corporation. Under the internal affairs doctrine, the Iowa court will apply New York corporate law. The important point is that either New York corporate law is being applied in Iowa or Iowa law is being applied in New York, even if neither corporation has any offices, factories, employees, directors, officers, or operations either in Iowa or in New York. In both cases, by virtue of this choice-of-law principle the corporate law of the state of incorporation has extraterritorial effect.

At first blush, this fact may appear to have only theoretical interest and no real-world importance; however, the opposite is true, because the internal affairs doctrine does not exist in a vacuum. It operates conjointly with two real-world facts. First, internal affairs disputes frequently involve large corporations that have far-flung operations. Second, a majority of those firms are incorporated in one

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[35] VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1113 (Del. 2005) (quoting McDermott Inc. v. Lewis, 531 A.2d 206, 216 (Del. 1987)).

[36] *See, e.g.*, W. Air Lines, Inc. v. Sobieski, 12 Cal. Rptr. 719, 722 (Dist. Ct. App. 1961) (recognizing validity of internal affairs doctrine, but holding that California law and law of state of incorporation may govern internal affairs if "the totality of California contacts so . . . require").

[37] It is assumed, for purposes of this hypothetical, that the court where the lawsuit is filed has personal jurisdiction over the parties.

state, namely, Delaware. These two facts give the doctrine real-world importance. Here is why.

First, assume that a lawsuit is filed involving the internal affairs of a mega-corporation having national or even global operations. Because all states have "long-arm" statutes that authorize *in personam* jurisdiction over foreign corporations that do business in, or have significant presence in, that state, that lawsuit potentially could be brought in a federal court or in the courts of several different states. Wherever the lawsuit is brought, because of the firm's sheer size, the economic stakes could be quite high, even of national magnitude. For example, a hypothetical lawsuit involving whether the board of DuPont may properly resist a takeover bid by Dow Chemical, or for that matter by a Chinese state-owned company, could determine the size of the chemical industry in the United States. Or, a lawsuit about whether a court should enjoin General Motors (GM), on fiduciary duty grounds, from proceeding with an agreement to sell GM or many of its automotive divisions to a foreign automobile manufacturer, would have a similar economic impact. The central point is that in both hypothetical cases the court would apply the law of the state of incorporation, even though public companies often will not have any operations or other presence in that state.

Now consider the second fact, which is that many of the largest firms in the country—that is, over a majority of both the Fortune 500 companies and the firms listed on the New York Stock Exchange (NYSE)—are incorporated in one state, namely, Delaware.[38] These mega-disputes, involving the internal affairs of America's largest companies, would be resolved under the corporate laws of that state. In practice these disputes are often resolved by the Delaware courts because so many internal governance lawsuits are filed in Delaware. But many governance lawsuits are also filed in state and federal courts in other jurisdictions, and under the internal affairs doctrine, those courts also apply Delaware corporate law. Because of the large number of Delaware corporate law cases, Delaware corporate jurisprudence has become more widespread and more developed than the corporate jurisprudence of other states.

In short, Delaware corporate law has come to have the largest extraterritorial effect because of the confluence of three factors: (1) the internal affairs doctrine; (2) the fact that a majority of the Fortune 500 and NYSE companies, and many other companies, are incorpo-

[38] Delaware is home to 61% of Fortune 500 companies and more than 90% of all United States–based public offerings in 2007 were incorporated in Delaware. Harriet Smith Windsor, Del. Dep't of State, Div. of Corps., 2007 Annual Report 1 (2007), *available at* http://corp.delaware.gov/2007DivCorpAR.pdf.

rated in Delaware; and (3) the fact that those companies have national (and in many cases, global) operations.

C. The Corporate Outreach Statutes

This brings me to the third and final way that reality has come to diverge from the federalist model—the so-called corporate outreach statutes adopted by California and New York. These statutes have extraterritorial reach because they legislatively overrule the internal affairs doctrine and impose their own, often different, internal governance requirements upon foreign corporations having a specified level of contact with the forum state.[39]

I will focus on the California outreach statute, not only because it is the most illustrative but also because it has actually been a subject of litigation. Section 2115 of the California Corporations Code requires certain foreign corporations to conform to a broad range of California internal affairs requirements. The statute defines a "foreign corporation" as a non-California corporation, half of whose voting securities are held of record by persons with California addresses, and half of whose business is conducted in California, as measured by a formula that considers California-based assets, sales, and payroll factors.[40] Excluded from the definition are foreign corporations whose stock is traded on a national securities exchange.[41]

Section 2115 provides that in cases where it applies, California corporate law will govern a host of internal governance matters. These include the annual election of directors, the removal of directors, the filling of director vacancies in specified circumstances, the directors' standard of care, directors' liability for unlawful distributions, indemnification of directors and officers, the requirements for annual shareholders' meetings, entitlement to cumulative voting, supermajority voting requirements, limitations on mergers and sales of assets, dissenters' rights, inspection rights, and records and reports. Lest there be any doubt about its intended purpose, the statute specifically provides that in cases where it applies, "*the foreign corporation's articles of incorporation are deemed amended to the exclusion of the law of the state of incorporation*."[42]

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[39] *See* CAL. CORP. CODE § 2115 (West Supp. 2009); N.Y. BUS. CORP. LAW § 1320 (McKinney 2003 & Supp. 2009).

[40] CAL. CORP. CODE § 2115(a).

[41] *Id.* § 2115(c)(1)–(2).

[42] *See* VantagePoint Venture Partners 1996 v. Examen, Inc. (*Examen II*), 871 A.2d 1108, 1114 (Del. 2005) (citing CAL. CORP. CODE § 2115(b) (West 1997 & Supp. 1984)) (emphasis added).

These outreach statutes are an effort, through legislation, by one state to give its corporate law extraterritorial reach. Foreign corporations that are subject to these statutes risk being caught in a crossfire between two conflicting sets of governance requirements—one imposed by the outreach statute of the forum state and the other mandated by the corporate law of the state of incorporation. Because a corporation cannot obey two conflicting legal commands at the same time, the issue becomes which state's corporate law will take precedence. That issue has been litigated in both California and in Delaware, and the results thus far have been a mixed bag.

In California, some court decisions have upheld the application of California governance requirements to corporations that had major California contacts but were incorporated elsewhere. In one case a California appellate court upheld an order of the California Commissioner of Corporations directing a Delaware corporation to observe California cumulative voting requirements.[43] Thereafter, in *Wilson v. Louisiana-Pacific Resources, Inc.*,[44] a California court upheld the imposition of that same cumulative voting requirement upon a Utah corporation with the requisite California contacts. Twenty years later, however, a California appellate court questioned the continued vitality of *Wilson*, given the broad acceptance of the internal affairs doctrine over the intervening period.[45]

This issue—which state's corporate law takes priority—has also been litigated in two Delaware cases, each involving a Delaware corporation caught between the conflicting internal governance requirements of California's outreach statute and Delaware's corporation law. In both decisions the Delaware court held that by virtue of the internal affairs doctrine, the Delaware corporate law trumped the conflicting California statutory rules.

The first case, *Draper v. Gardner*,[46] was an appeal from a Court of Chancery order that allowed the plaintiffs in a Delaware stockholders' derivative action to voluntarily dismiss their lawsuits in favor of virtually identical California state court actions. The defendants, who were directors of a Delaware corporation with significant California contacts, asked the Delaware Supreme Court to reverse the lower court's dismissal of the Delaware action. The directors claimed

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[43] W. Air Lines, Inc. v. Sobieski, 12 Cal. Rptr. 719, 728 (Dist. Ct. App. 1961).

[44] 187 Cal. Rptr. 852, 857–58 (Ct. App. 1982).

[45] *See* State Farm Mut. Auto. Ins. Co. v. Super. Ct., 8 Cal. Rptr. 3d 56, 63, 67–69 & n.3 (Ct. App. 2003) (applying law of defendant corporation's place of incorporation, rather than California state law, after finding that "the parties' dispute involve[d] the internal affairs of the company").

[46] Draper v. Gardner Defined Plan Trust, 625 A.2d 859 (Del. 1993).

that they would be prejudiced if required to defend in California, because the California courts would apply California's internal presuit demand requirement, which they claimed was less favorable to them than the counterpart Delaware rule. Rejecting this argument, the Delaware Supreme Court ruled that it would not presume that the California court would refuse to apply the internal affairs doctrine, which (the Delaware court held) was not only clearly applicable but also of constitutional dimension.[47]

The second Delaware case, *VantagePoint Venture Partners 1996 v. Examen, Inc. (Examen II)*,[48] also involved a conflict between Delaware and California corporate law requirements, but this conflict was much more sharply focused than the one in *Draper*. Examen was a Delaware corporation that did significant business in California. It had two classes of stock, common and preferred. Over 83% of the preferred was owned by VantagePoint, a venture capital firm. In 2005, Examen and another company, Reed Elsevier, agreed to merge. VantagePoint opposed the merger, but lacked enough votes to defeat the merger under both Delaware law and Examen's charter, which required that the merger be approved by a majority of the outstanding common and preferred stock, voting together as a single class. But if California's outreach statute applied, then VantagePoint could defeat the merger because California corporate law required the approval of both the common and the preferred stock, each voting as a separate class.[49] As the owner of 83% of the preferred stock, under California law VantagePoint could veto the merger singlehandedly.

The dispute came to a head when Examen sued VantagePoint in the Delaware Court of Chancery, and VantagePoint sued Examen in a mirror image California state court action. Examen sought an expedited judgment that under Delaware law, VantagePoint was not entitled to a separate class vote on the proposed merger. In its California lawsuit, VantagePoint asked the court to rule in precisely the opposite way. An impending collision between these two courts was avoided by the California court staying the VantagePoint lawsuit until after the Delaware court decided a motion for judgment on the pleadings.

The Delaware court granted judgment for Examen, holding that Delaware, not California, law governed how the stock should be

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47 *Id.* at 869.

48 871 A.2d 1108 (Del. 2005).

49 *Id.* at 1109–10 n.1; *see* CAL. CORP. CODE § 2115 (enumerating factors that may subject foreign corporations to laws of California); *id.* § 1201 ("The principal terms of a reorganization shall be approved by the outstanding shares . . . of each class of each corporation the approval of whose board is required . . . .").

voted.[50] VantagePoint appealed to the Delaware Supreme Court, which affirmed. That court held that because Examen was a Delaware corporation, the internal affairs doctrine applied as a matter of constitutional law. Therefore Delaware law, rather than the law of California, governed.[51]

The "hot button" question is: When an outreach statute and the internal affairs doctrine come into conflict, as they did in the two Delaware cases, which will trump the other? The question is ultimately one of constitutional law. As the law currently stands, there is no single answer because the answer depends upon which state's jurisprudence—Delaware's or California's—a court will look to when deciding that question.

This brings me to my third and last topic. We now know that a state's corporate law may reach beyond its borders even though under the corporate federalist model it should not. We also know that two of the three ways under which this can happen could set, at least potentially, a collision course that may affect more than just the two states whose corporate laws are in conflict. The question becomes: How will this uncertain state of affairs unfold in the future?

III
What Will the Future Look Like?

In guessing what the future may hold, there are several possibilities, but they all turn on one question: whether the internal affairs doctrine is only a choice-of-law rule or whether it is also a rule of constitutional law. If the doctrine is only a choice-of-law rule, then any state is free to adopt or reject it.[52] If it is a principle of constitutional law, then no state is free to reject it. The only court that can decide that question with finality is the United States Supreme Court, and thus far, the question has not percolated up to that level.

But suppose it does. A case could arise involving facts similar to those in *VantagePoint* but with an additional twist. Suppose, as in *VantagePoint*, that identical lawsuits are filed in Delaware and in California, but instead of only one court deciding the case, both courts

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[50] Examen, Inc. v. VantagePoint Venture Partners (*Examen I*), 873 A.2d 318, 325 (Del. Ch. 2005).

[51] *Examen II*, 871 A.2d at 1116 ("Delaware's well-established choice of law rules and the federal constitution mandated that Examen's internal affairs . . . be adjudicated exclusively in accordance with the law of its state of incorporation, in this case, the law of Delaware." (internal citations omitted)).

[52] Many states have modeled their corporations statutes on the Model Business Corporation Act, which explicitly "does not authorize [the forum] state to regulate the . . . internal affairs of a foreign corporation." Model Bus. Corp. Act § 15.05(c) (2005).

proceed simultaneously and come out in opposite ways. That is, the Delaware Supreme Court decides that the California statute does not apply because the applicable law is the internal affairs doctrine, which it deems a rule of constitutional law. The California court (let us assume) decides that the internal affairs doctrine is a non-binding choice-of-law rule that the California legislature is free to reject. Those two diametrically opposite hypothetical rulings would subject the Delaware corporation with substantial California contacts to two conflicting voting requirements. Needing to know which requirement must prevail, the Delaware corporation would ask the United States Supreme Court to review the California decision. The corporation would claim that the California statute, as applied, violates the Due Process and the Commerce Clauses of the United States Constitution.[53]

If the Supreme Court were to take that case, we can only guess how it would be decided. Language in the earlier *MITE* and *CTS* decisions would give the corporation a strong argument that the Supreme Court has already recognized the constitutional dimension of the internal affairs doctrine.

The corporation would also strongly rely on a later case, *Kamen v. Kemper Financial Services, Inc.*[54] The issue in *Kamen* was whether the federal courts could superimpose, as a matter of federal law, a universal pre-derivative suit demand requirement that would displace the states' counterpart demand rules.[55] The Supreme Court held that this could not be done because a federally imposed universal demand rule would disrupt the internal affairs of corporations chartered under state law. If a universal demand rule in federal courts would be disruptive because the demand rule of the state of incorporation would be different, then (the argument would run) it would be equally, if not more, disruptive to allow California's expansive menu of different internal affairs rules to trump the counterpart rules of the state of incorporation.

I personally subscribe to the view that the stability and certainty afforded by the internal affairs doctrine justifies according that doctrine constitutional status. But my personal view is of minimum relevance. The question is debatable, and legal commentators have lined

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53 *See, e.g.*, McDermott, Inc. v. Lewis, 531 A.2d 206, 216–17 (Del. 1987) ("[W]e conclude that application of the internal affairs doctrine is mandated by constitutional principles, except in 'the rarest situations.'" (citation omitted)); *Continued Primacy*, *supra* note 28, at 1490–96 (discussing potential applicability of Due Process Clause, Full Faith and Credit Clause, and Dormant Commerce Clause).

54 500 U.S. 90 (1991).

55 *Id.* at 92.

up on both sides of the debate.[56] So, any prediction about how the nation's highest court might rule would be hazardous. It is more productive, in my opinion, to tease out what might happen under both scenarios.

Let us first assume that the Supreme Court decides that outreach statutes such as California's are constitutional. Should this occur, I predict that the legislatures of other states will adopt various forms of outreach statutes, at the behest of shareholder activists and other interest groups. Those statutes would likely impose various, perhaps highly idiosyncratic, kinds of corporate governance requirements upon foreign corporations that do business in those states.

Were that to happen, what would the landscape look like? I suspect it would resemble a corporate law version of the "Gunfight at the O.K. Corral." Companies that incorporate in one state but do business in several states could find themselves subject to inconsistent internal governance requirements. *VantagePoint* illustrates the sort of problems that such a rule could create: potentially conflicting fiefdoms that apply equally valid but conflicting laws to the same corporation. Were those problems to become widespread and frequent, it could become economically disruptive. Corporations facing the impossibility of complying with two or more inconsistent governance requirements might simply choose not to do business in the states having inconsistent rules—a choice that could distort economic incentives and to some extent inhibit economic growth. Or, those corporations might instead choose to create separate subsidiaries to operate in each state in which they do business. Creating new levels of corporate ownership may solve the inconsistency problem, but it would inflict other costs, not limited to additional taxes and possibly increasing the cost of capital.

Were this state of affairs to become sufficiently disruptive, it could create pressure for Congress to eliminate the conflict by enacting some kind of preemptive uniform legislation. The least intrusive form of such legislation—that is, the kind that would preserve the states' authority to regulate corporations chartered under state law—would mandate the internal affairs doctrine on a nationwide basis, in effect overturning our hypothetical Supreme Court deci-

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[56] *See, e.g.*, Norwood P. Beveridge, Jr., *The Internal Affairs Doctrine: The Proper Law of a Corporation*, 44 BUS. LAW. 693, 719 (1989) (arguing that internal affairs doctrine should not be "blindly adopted"); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 96 (suggesting that anti-takeover statutes "fall within the ambit" of state powers to regulate foreign corporations); *Continued Primacy*, *supra* note 28, at 1501 (arguing that costs of state legislatures' overruling internal affairs doctrine may outweigh benefits).

sion upholding the outreach statutes. The most intrusive—that is, the kind that would be least protective of state sovereignty—would be a federal corporation law that would displace the corporation law of all fifty states. For those of us who have devoted a professional lifetime to shaping and improving corporate governance law at the state level, that would be a most unfortunate development, if only because it would create rigidity and retard experimental (and, hopefully, beneficial) change. Experience shows that laws once enacted by Congress, even if flawed, become politically difficult, if not impossible, to change.[57] In contrast, imperfect laws that are enacted by state legislatures or imperfect rules crafted by judges as part of the common law adjudication process tend to be more easily correctible.

Now, assume the alternative scenario—that the Supreme Court decides that the internal affairs doctrine is also a rule of constitutional law. In that event, the corporate outreach statutes would be invalid, at least as applied to foreign corporations whose state of incorporation imposes inconsistent requirements. There would be a clear, easily applied rule that wherever a lawsuit involving the corporation's internal affairs is filed, only the law of the state of incorporation would govern the case. That would essentially preserve the status quo, but it is important to keep in mind that the status quo is not necessarily static or quiescent. Far from it. For years other states have been competing with Delaware, and with each other, to encourage firms either to incorporate or reincorporate in their jurisdictions.[58] If the internal affairs doctrine were to become the universal rule, that competition could well intensify.

By way of example, beginning in the 1980s, thirty-one states, including Pennsylvania, Virginia, and Rhode Island, adopted so-called "other constituency" statutes.[59] These statutes did two things. First, they relieved target company boards from any obligation, in responding to a takeover bid, to treat the interests of shareholders as paramount over all others. Second, they permitted those boards to consider the effects of a hostile takeover on other constituency groups, such as employees, suppliers, customers, creditors, and local

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57 *See, e.g.*, GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 2 (1982) (discussing "problem of legal obsolescence" and arguing that "because a statute is hard to revise once it is passed, laws are governing us that would not and could not be enacted today"); GRANT GILMORE, THE AGES OF AMERICAN LAW 95 (1977) ("[G]etting a statute enacted in the first place is much easier than getting the statute revised so that it will make sense in the light of changed conditions.").

58 *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 9–11 (1993) (describing interstate competition for corporate charters).

59 *See, e.g.*, 15 PA. CONS. STAT. ANN. §§ 1715(a)–(b) (West 1995); VA. CODE ANN. §§ 13.1-690, -728.9 (2006); R.I. GEN. LAWS § 7-5.2-8(b) (1999 & 2008 Supp.).

communities.[60] Essentially, these statutes were a legislative rejection of Delaware case law, specifically the *Unocal* and *Revlon* decisions,[61] which imposed greater limitations upon how directors may respond defensively to hostile takeover bids.[62] Another example: In 2007, at the behest of institutional investors, North Dakota amended its corporations statute to mandate so-called "shareholder friendly" requirements such as majority voting for directors, advisory shareholder votes on compensation reports, giving shareholders holding five percent or more of the company's stock access to corporate proxy machinery to nominate a dissident director slate, and mandatory expense reimbursement for waging successful proxy contests.[63] That amendment was regarded as a vehicle for institutional investors to persuade their portfolio company boards to reincorporate from Delaware to North Dakota.

If the Supreme Court were to constitutionalize the internal affairs doctrine, absent preemptive federal legislation, we could expect more and different forms of this kind of competition among states for incorporation business and the franchise tax income it generates. That is, in an internal affairs doctrine world, there would be competition, but there would be no irreconcilable direct conflicts imposed on individual firms. Different states would offer an array of legal choices, and corporations would choose whatever legal regime they prefer, as they do now.

Conclusion

I hope these remarks have helped convey to you some of the flavor of the ever-changing system that we loosely describe as corporate federalism. It is complex; it does cross state lines; it has a lot of moving parts; but by the same token it has also provided employment for many fine members of the bar, the judiciary, and the legal academy. I thank you for your kind attention.

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[60] *See* Stephen M. Bainbridge, Corporation Law and Economics 741–47 (2002) (describing content and significance of these "nonshareholder constituency statutes").

[61] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) (discussing obligations of directors in relation to defensive measures to thwart takeovers); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986) (describing fundamental duty of care of directors in defensive measures).

[62] In this regard the Indiana statute could hardly be more explicit:

> Certain judicial decisions in Delaware . . . relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article.

Ind. Code § 23-1-35-1(f) (2009).

[63] N.D. Cent. Code §§ 10-35-01 to -33 (Supp. 2007).