Delaware and Democracy:
Foreign Corporations, the Internal Affairs Doctrine,
and the Race to the Bottom/Top
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Democracy and Delaware:  
Foreign Corporations, the Internal Affairs Doctrine,  
and the Race to the Bottom/Top

I. INTRODUCTION

American corporate law is based on a great constitutional puzzle. Delaware’s dominance of our national corporate law, on its face, defies fundamental notions of democracy, self-government and federalism.

First, the Delaware legislature doesn’t represent us — non-Delaware Americans — even virtually or indirectly. Yet it governs the great multi-state and multi-national public corporations — our most important non-governmental institutions. Through them, Delaware governs each of us in our roles as consumers, investors, employees and neighbors.

As a purely formal matter, Delaware is defying the basic premise of a territorial based union, governing extraterritorially without giving us a vote.

Second, the substantive reality is even more troubling. Even Delaware does not control corporate law: corporations in effect choose their own law. Although conventional wisdom often views free choice of law by corporations as proof that corporate law is voluntary (and hence not problematic, perhaps even trivial), the argument makes little sense. The people who choose the law – corporate managers, acting on their own behalf or under the influence of role requirements and market pressures – are not the same people as those controlled by it. Corporate law norms help determine how corporations function and structure the markets that are more important direct influences on corporations. These norms, markets and corporations in turn affect nearly all of us as employees, consumers, shareholders and citizens.

The current corporate law system excludes corporate norms from political debate. In the standard account, Delaware is a victor in an interstate competition for franchising fees and other revenues associated with incorporating out-of-state firms – usually described as a race to the top or a race to the bottom. If that is true, the system we live by seems to preclude substantive political debate about the important value conflicts in corporate law:

No matter how much the citizens of New York or California, or the entire country, wished to create a corporate law reflecting a different view of the rights and responsibilities of corporate constituents, they would be powerless to prevent corporate managements from simply opting out of their law.

Corporate managements, in turn, are driven by self-interest and market pressures to pick that law that gives them the maximum freedom to increase private shareholder profits – even by clearly socially detrimental externalization of private costs and regardless of competing
social values. In this system, even the citizens of Delaware have little ability to influence our corporate law. Not only does Delaware not represent us, no government does.

Third, crassly and perhaps most inexplicably, the conventional picture is one of interstate exploitation. The race to the top/bottom account makes clear that Delaware is picking the pockets of the citizens of the commercial states: every dollar paid to Delaware in franchising fees is a tax dollar paid by a voter without representation in the taxing jurisdiction, and every dollar paid to a Delaware lawyer is a dollar that could have gone to develop the legal system of the firm’s host state.

A federalist system should not tolerate one state taxing citizens of other states, let alone legislating for them. A republican system should not tolerate the citizenry abdicating their obligation of self-rule, at least in the absence of a clear and explicit political decision to do so, and should have mechanisms for virtue, not merely self-interest, to be expressed in the public forum. Law in a democracy ought to be the product of a debate about conflicting values ultimately determined by majority vote of the citizenry, not the unilateral creation of a tiny political subdivision responsive primarily to institutions that have escaped from popular control. A liberal, market based system of private rights ought to have political procedures in place to protect individual citizens from overreaching by unelected leaders of bureaucratic institutions responsive to a set of norms not necessarily those of the populace.

In short, Delaware corporate law — regardless of its substantive merits — seems to contradict the norms (if not always the doctrines) of the federalism and the Commerce Clause (Delaware is extensively regulating and taxing the economic affairs of other states); one person one vote (again, we never voted for Delaware); equal protection (Delaware taxpayers and voters receive a set of privileges denied the rest of us); the Republican Form of Government clause (the race to the top/bottom, by allowing corporate managers to choose the law that determines their own powers creates an elite that governs us, the citizenry, without being answerable to political processes); and full faith and credit (Delaware’s extra-territorial legislation governs a significant part of the economic affairs of other states in defiance of their equal sovereignty).¹

¹Substantively as well, Delaware law has a key characteristic that seems to contradict fundamental democratic and republican norms. It teaches corporate administrators to view all corporate participants other than shares as mere tools to be exploited to degree practical for an end outside themselves: all the humans associated with the corporation should be treated as mere tools towards the ideal of profit maximization. See [below, and Fictional Shareholders]. In a democratic republic, citizens ought to be the ends, never merely the means, of social institutions. See [Rutgers essay]. Less abstractly, corporations, as the place in which we live much of our lives, necessarily embody many values other than profit maximization; Delaware corporate law, however, suppresses those other values in favor of a peculiarly shortsighted version of profit.
Conventional wisdom assumes that the race to the top/bottom, whether desirable or not, is an inevitable result of our federalist system. On this view, so long as corporate law remains the bailiwick of the states, the commercial states must allow Delaware to set the rules for (and siphon off some of the taxes from) their major enterprises, and American citizens must allow corporate managers, acting under market pressures, to determine the corporate law that ought to be structuring that very market and those very choices. Indeed, Delaware, relying on a strong reading of two U.S. Supreme Court cases, has declared that the current system is constitutionally mandatory, part of the fundamental bargain that created the United States. (Pre-New Deal Supreme Court cases also suggested — using a variety of often incompatible theories — that the current system may have some Constitutional status.)

This conventional wisdom is deeply implausible. The race to the top/bottom is a market-like process of structured competition in which social norms are created by uncoordinated separate decisions. Market structures, as lawyers have acknowledged at least since the demise of Lochner, are always legitimately subject to political debate and change: if we don’t like the results that markets generate, we can change the rules and they’ll generate different results. Post-Lochner Constitutional law should not require any particular set of market structuring rules. Delaware’s argument seems almost precisely backwards: to the extent that the Constitution has anything to say at all about making of corporate law, one would expect that it would be to demand that corporate law, whatever it is, be subject to the ordinary political processes of a democratic, market-liberal, republic. It would be extraordinary if the Constitution protected a particular, highly contingent, result of an early 20th century political conflict and the market-like system for choice of law it created — all the more so since every arguably relevant Constitutional text long predated modern corporate law, the rise of the national economy and the multi-state and multi-national corporation, and the race to the top/bottom itself.

Closer examination reveals the following. The Internal Affairs Doctrine’s dominance rests on three myths: venerability, inevitability, and determinancy.

First, the Internal Affairs Doctrine — the doctrinal basis for Delaware’s dominance — is no hoary product of the common law, but a relative newcomer to the scene. It originated as a jurisdictional rule — long since abandoned — holding that states could not assert personal jurisdiction over corporations incorporated elsewhere. With the rise of modern doctrines of jurisdiction, the old doctrine transformed into something quite different: a judicially created presumption that state legislatures do not intend to regulate the “internal” workings of corporations incorporated under the law of a different state. In Federal law the doctrine survived not only these transmutations but the demise of Federal common law, reappearing, at least at the margins, as an exception to the usual rules of distributions of power among the states. Through this long and mutable history, it is difficult to find a persuasive justification
for the doctrine’s survival: it exists, like the QWERTY keyboard, largely because it exists, seems always to have existed, and therefore must be appropriate.

Second, the Internal Affairs Doctrine, by its own terms, is not an inevitable result of a federal system but a mere default rule that can easily be abandoned, should states chose to do so. For most of the modern period, the Internal Affairs doctrine has been viewed as a court-imposed choice of law doctrine, to be used by the host state in the absence of an important state policy or any statute to the contrary. That is to say, any state that chose to opt out of the competition and to regulate its own enterprises regardless of their nominal incorporation was free to do so. And in practically minor, but theoretically critical, ways, several states have done so.

Thus, California, New York and Wisconsin(?) have each placed limits on the limited liability of corporations doing business in those states regardless of their state of incorporation: where foreign corporations injure local creditors, those states at times have imposed their own law, rather than the law of the state of incorporation, to determine whether shareholder assets can be reached by corporate creditors. California has required corporations incorporated elsewhere to follow California norms regarding shareholder norms and the allocation of power between minority and majority shareholders, when the foreign corporation has a closer nexus to California than any other state. New York has extended shareholder inspection rights to all corporations in the state and limited their ability to issue dividends that might harm creditors, apparently extending its law to the full extent of ordinary constitutional limitations on application of forum law. New Jersey has imposed New Jersey fiduciary obligations on managers of foreign corporations doing business there, applying standard choice of law norms rather than the internal affairs doctrine. Even the R.M.B.C.A. appears to recognize that the internal affairs doctrine is a mere matter of the host state’s legislative grace: the fact that it explicitly enactments the doctrine implies that a state could also decide not to enact it.2

In short, for as long as firms have sought to escape regulation by incorporating elsewhere, states have resisted, at least at the margins. These small limitations on the internal affairs doctrine point the way for larger ones: only political will, not principle, stands in the way of individual states ending Delaware’s violations of federalism.

Third, the Internal Affairs Doctrine has little definitive content: although courts frequently apply it, generally without even considering its appropriateness, virtually every aspect of internal affairs has been declared external by some court at some time. (Indeed, large areas of apparently internal affairs have simply been redefined as securities law, and removed from state regulation entirely).

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2 R.M.B.C.A. 15.05 “This chapter does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.”
The doctrinal indeterminancy of the internal/external affairs line points to a more important problem: while the dominant academic model regards corporate law as purely private contracting with no social implications (and thus sees the only choice of law values as predictability and contractual autonomy), in fact corporate law regulates social governance institutions that affect every aspect of our lives. Because corporate law structures how private decisionmakers will act, in ways that in turn impact upon other parties, and because it involves balancing important and often inconsistent values, it is an important part of our self-governance. In other words, the reason the doctrine is unstable is simply that the distinction is wrong. Purely “internal” corporate governance issues nearly always have effects that go well beyond the corporation and its shareholders, creating significant consequences for the citizens of the corporation’s host state. Internal governance is external. Accordingly, when courts bother to go beyond mechanical analysis they naturally will tend to resist the peculiar notion that a state is barred from protecting its citizens.

Stripped of the support of these three myths, Internal Affairs can not withstand serious scrutiny. The states are largely free to resist Delaware’s infringement of their sovereignty even under current doctrine and they ought to do so. The standard defenses of free corporate choice of law – uniformity and predictability – while clearly virtues, are less clearly virtues if the uniform and predictable law is bad law, and free choice of law is no virtue at all when the decisionmakers are permitted to choose law that allows them to impose on others not involved in the choice.

The inadequacy of the standard defense of the status quo is most obvious where Delaware’s taxation of out-of-state Americans is concerned: neither uniformity, predictability nor free choice explains why the commercial states should allow Delaware to off-load its taxes onto them. But taxes are only a small aspect of a larger problem. All “internal affairs” issues potentially affect “outsiders” not involved in corporate managers’ choice of law, because, put simplistically, corporate law defines all corporate participants other than shareholders as outsiders. Indeed, even the views and interests of the human beings who own (or are the beneficiaries of institutional owners of) shares typically are excluded from corporate law’s “internal” considerations. But these “outsiders” are all the human beings associated with public corporations: if corporations have any significance at all (and obviously they have enormous significance) their internal affairs must affect “outsiders.” Once we recognize that outsiders, however defined, have been or might been injured, it is difficult to understand the logic of blind deference to another state’s decision to leave injury unremedied.

The unthinking acceptance of the status quo rests, rather, on a combination of metaphors and arguments that can not withstand scrutiny: a claim that corporate law doesn’t matter (and so it doesn’t matter that we are precluded from making corporate law that would matter), claims that markets necessarily generate perfect law (so we shouldn’t be concerned
about the anti-democratic and anti-federalist nature of Delaware’s imperialism); claims that
the current system protects the autonomy of shareholders in a classic liberal freedom from
government manner (ignoring the uncomfortable legal reality that corporate law largely
excludes from consideration the actual views of actual shareholders); claims that
corporations as legal persons ought to share in the rights of citizens, or that their assertions
of rights can be easily understood as assertions of the rights of their human shareholders or
even non-shareholders; and so on. These metaphors, however, are not a substitute for
actual consideration of whether we, the citizens, have the right to control the corporate law
that creates the corporations that, in turn, often control us.

The argument of this Article, however, is principally procedural. Even if Delaware’s
corporate law were in fact substantively optimal, the Internal Affairs Doctrine should be
resisted. Free corporate choice of law means that no political body takes responsibility for
the consequences of corporate law. If current corporate law were perfect, it would be able
to prevail in a democratic forum; if the current law exists only because of this deeply
distorted procedure, perhaps it is not as optimal as it is claimed to be.

Finally, were states to begin to resist Delaware’s infringement on their sovereignty,
corporations would respond in predictable ways, including by changing their structure to
reflect the new legal regime. These responses might well limit individual states’ ability to
use corporate law to restructure the corporate marketplace impose substantive regulation.
Abandoning the Internal Affairs Doctrine would by no means eliminate the ability of
corporations to free themselves from law they find unattractive by, for example, simply
leaving the relevant jurisdiction. Nonetheless, the states would gain greater freedom to
structure the law in ways that reflect social values than is presently the case.

To the extent that uniform and predictable corporate law is in fact a market need (and
not just a convenient justification for the status quo), corporations should be able to
reconstruct it through private responses, principally by incorporating subsidiaries in the
jurisdictions in which they do business. However, even if I am wrong and uniformity is both
quite important and impossible to achieve by private action in a federal system, the correct
political response – the only one that incorporates democratic and republican values into
corporate law – is to expand the scope of the Federal securities acts. That is, if in fact we
need a uniform national corporate law, it should be enacted by our national legislature, not
Delaware.

II. UNDEMOCRATIC LAW/UNREPUBLICAN LAW

[This entire section seems duplicative of the introduction. Eliminate.]

Corporate law is undemocratic. The Delaware legislature has no claim to represent the
American people; an unrepresentative institution, in defiance of fundamental democratic
norms, is legislating for us without even claims to virtual or indirect representativeness. As
In fact, the Delaware legislature appears to delegate its corporate lawmaking function to a committee of the Delaware bar: thus, we are governed by an unelected group of corporate lawyers responsive, one assumes, only to the needs of themselves and their clients. Corporate lawyers are typically hired by corporate management; never by citizens at large, representatives of employees, consumers, or the social or natural environment. Thus, Delaware’s law making process assures that no values will be reflected in Delaware corporate law except as mediated through corporate management. To be sure, to the extent that corporate management feels it must respond to demands of the financial markets or other markets or market participants, those demands may pass through to corporate law (unless, of course, managers believe they are better off responding by using corporate law to defend themselves from outside demands). For a description of Delaware’s law making processes, with a suggestion that it improves Delaware’s attractiveness to managers by eliminating competing values, see, Curtis Alva, Delaware and the Market for Corporate Charters: History and Agency, 15 DEL. J. CORP. LAW 885 (1990) e.g, at 898 (“party politics play no part in the formation of the Del. GCL. Neither party has ever formally supported or opposed any corporation law bill.”).

Substantively, the reality is even more troubling. Even Delaware does not control corporate law: corporations in effect choose their own law. In some respects, free choice of law looks like a paradigmatic example of liberal freedom from non-consensual power: what could be more legitimate than law one chooses oneself? But corporations are not citizens, and corporate freedom often is not the same as individual freedom; just as freeing the state is often oppressive to its citizens, so too with corporations. Governance institutions need to be responsive to the needs and desires of their constituents, not freed from them.

The argument proceeds in four steps. First, I take it as relatively non-controversial that in the ordinary case, law should be enacted by institutions that are responsive to those who are governed. If Delaware purported to enact tax or tort law for the entire country, little argument would be necessary to demonstrate that this would violate ordinary principles of federalism, comity and democracy. So, the heart of the argument must be examination of the reasons why corporate law might be different. I see two basic claims here.

On the one hand, some observers claim that corporate law doesn’t matter. On this view, corporate law is entirely voluntary and consensual, a liberal paradigm of non-oppressive law. Since no one is subject to corporate law unless they choose to be, representative democracy is otiose and irrelevant: corporate law answers to a higher standard of pure consensual government. In effect, this analysis claims, corporate law represents the “laws that are guides to keep men in their ways” to which Hobbes aspired, and the entirely consensual anarchism that Robert Paul Wolff contended is the only truly just government. My response is two fold: From an internal corporate perspective, corporate law matters because even if corporations choose their own law, it is false to suggest that that implies that the human beings who compose the corporation have chosen the law. Second, from an external

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3In fact, the Delaware legislature appears to delegate its corporate lawmaking function to a committee of the Delaware bar: thus, we are governed by an unelected group of corporate lawyers responsive, one assumes, only to the needs of themselves and their clients. Corporate lawyers are typically hired by corporate management; never by citizens at large, representatives of employees, consumers, or the social or natural environment. Thus, Delaware’s law making process assures that no values will be reflected in Delaware corporate law except as mediated through corporate management. To be sure, to the extent that corporate management feels it must respond to demands of the financial markets or other markets or market participants, those demands may pass through to corporate law (unless, of course, managers believe they are better off responding by using corporate law to defend themselves from outside demands). For a description of Delaware’s law making processes, with a suggestion that it improves Delaware’s attractiveness to managers by eliminating competing values, see, Curtis Alva, Delaware and the Market for Corporate Charters: History and Agency, 15 DEL. J. CORP. LAW 885 (1990) e.g, at 898 (“party politics play no part in the formation of the Del. GCL. Neither party has ever formally supported or opposed any corporation law bill.”).

4But see Alva, supra n. 3, at p. 908 (quoting A. Gilchrist Sparks III, then Chairman of the Corporate Law Section of the Delaware Bar, partner at Morris, Nichols, and a leading member of the Delaware corporate bar, as referring to “Delaware corporate citizens”). Sparks’ odd locution – business corporations are tools of the citizenry, but they are not themselves citizens any more than are public corporations (governmental units) – supports the conventional view that corporations, not human citizens, create and control corporate law.
perspective, corporate law affects many people who are not part of the supposed free bargain. In particular, external regulation will never be as effective as the internal structure of the corporation in determining its behavior, for simple Adam Smithian reasons: corporate managers will always be more assiduous in pursuing their own interests (as structured by corporate law). If we can harness those interests for the public good, we are far more likely to end up where we want to than if we attempt to suppress them by external regulation. Corporate law determines what the interests of the corporation are and thus is the most powerful regulatory law available.

Corporations, in my view, can never be simply analogized to human beings. They are far more like governments: structures created by humans to serve humans which can easily escape from control of those they are meant to serve, imposing coercive norms that can as easily reduce freedom as increase it. Allowing corporations to choose their own law is, thus, no more likely to increase human freedom than allowing governments to choose their own law would be. The question is, as Humpty Dumpty put it, which is to be the master, and if we wish to be the master, corporate law will generally be the most effective way to do it. Corporate law, in short, matters a good deal. Far from empty girders, it is the determinative structure pointing the market in the direction it will go. This Part of this Article discusses the status of corporate law as a matter of liberal theory, seeking to explain why free choice of corporate law paradoxically reduces human freedom.

On the other hand, some observers take the Internal Affairs Doctrine as a fact of legal life. If Internal Affairs is written in stone, then there is little point in discussing whether specific corporate law doctrines are socially beneficial: corporations and corporations alone will determine whether the doctrines live or die. Part III of this paper will explore in detail the true status of the Internal Affairs Doctrine.

Corporate law is sometimes claimed to be purely empty or formal and thus of little importance. If this were true, perhaps the undemocratic Delaware system would be practically trivial even if theoretically indefensible. But the empty girders of corporations law do perform at least one critical function of significant, public, importance. Corporate law determines the extent to which corporations respond to their constituents. Indeed, it defines who those constituents are. Corporate law, that is, defines whom corporate managements should be working for and whom it should view as outside the firm — whose benefits, that is, are profits for the firm and whose are costs.

Corporate law gives the captain great autonomy to pursue the interests of the team. The doctrine of centralized management ensures that shareholders have virtually no right to intervene in managerial decisionmaking: shareholder elect directors, but cannot tell them what to do. Then, the Business Judgment Rule assures that any judicial review will be deferential in the extreme. The combination seems to leave corporate managers either able to run the firm solely in their own interest (the race to the bottom view) or subject mainly to
market, rather than legal limitations (the race to the top view). I have argued elsewhere that corporate law is not quite this empty: in fact, the law specifies a set of hypothetical interests and real goals (roughly speaking, share value maximization). Moreover, it creates strong incentives for managers to follow them - both because as professionals managers must, if they are acting in good faith, pursue the legally created end, and because the law gives institutional investors and other market players the tools and incentives to press corporate managers to stick to the legally mandated goals of corporate law. Thus, corporate law actually has quite a bit to say about the interests of the team.

For present purposes, however, a different aspect of corporate law is even more important: corporate law defines the team for which managers play. That is, it is corporate law that determines that some participants in the corporation are outsiders, deemed to be competitors to the firm whose gains are “costs” to the firm, while others are insiders, whose gains are profits to the firm. To some degree, of course, this legal classification is purely formal: firms may with more or less difficulty choose alternative organizational forms with different classifications. Thus, in a partnership, payments to key personnel -- the partners -- are classified as profit to the firm, so that the more they make, the more the firm makes, whereas in a corporation payments to key employees are classified as costs that reduce the firm’s profits (unless the payments are in the form of stock options). Nonetheless, and especially with respect to enterprises that are sufficiently large as to require financing from the public markets, the legal forms matter. Managers predictably will act differently with respect to participants who are designated members of the team than those who are seen as competitors.

American corporate law, scholars are largely agreed, is created by a process of competition between the states. States, seeking to obtain revenues for the privilege of incorporation, offer statutes; corporate managements then choose the statutes they find most attractive. Academic debate centers on the degree to which managements are constrained by market forces to pick law that is also attractive to shareholders: those who believe in constrained managers describe a race to the top, while those who believe that managers can freely choose law that allows them to exploit shareholders describe a race to the bottom.

The conventional picture raises a difficult puzzle. Delaware, the victor in the competition, is engaged in a deeply problematic effort to exploit its fellow states. Delaware franchise taxes (and associated legal revenues) are paid by corporations that are largely based elsewhere: their shareholders, employees, creditors and customers are, overwhelmingly, not Delaware citizens. Precisely which human beings pay corporate taxes (and legal expenses) is a matter of some controversy — but regardless of which corporate constituents bear the
ultimate burden of Delaware’s taxes, clearly they are out-of-state, non-Delaware citizens. On its face that is, in words well-known to all Americans, taxation without representation.

Moreover, corporate law clearly affects non-Delaware citizens in many other ways. By defining the membership of corporations, corporate law determines which corporate constituents may be legitimately treated as outsiders or costs, to be given the minimum benefits permitted by law and market, and which are to be treated as beneficiaries, for whom the corporate leaders have a fiduciary obligation to do as much as possible. By constructing the legal fiction of the shareholder, corporate law tells managers for what they are acting and what is a respectable way to behave: that is, as I’ve described at length elsewhere, the law tells managers which values they should pursue and which they should set aside, defining the role of professional managers and limiting the scope of his (or occasionally, her) concerns in running the company.

By defining limited liability, voting rights, continuity, and mobility, corporate law determines the extent to which other, substantive, regulations will find a determinate corpus to regulate. If corporate law makes it too easy to legally separate assets from potential liabilities, regulators will find there is no there there to regulate. A firm that can simply disappear at will is not likely to be motivated by fear of tort or contract judgments, ERISA, Superfund or even specific injunctions.

Conversely, too rigid corporate law can have devastating impacts on the economy as a whole. First, there is a simple problem of corruption, well known from governmental analogues. If corporate managers are immune from outside attack, top managers may find that (given their limited life expectancy at the top) their own self interest is best fulfilled by ignoring corporate competitiveness in favor of short term shifting of corporate assets to their personal bank accounts. Top managers are typically nearing retirement age; they will often be playing an end game. Why, then, worry about reputational concerns or the possibility of settling up in the next period: Apres moi le deluge.

Other problems are more structural. If corporations can fund their growth largely internally, Alan Greenspan’s control over interest rates becomes far less significant. If corporations are run too much in the interests of employees they may develop into the classic clumsy bureaucracies we all know and hate. If they are run too much in the interests of bondholders, they may lose the ability to take risks or respond to a changing world. If they are run too much in the interests of shareholder we may find all continuity disappearing, enormous pressures to externalize expenses onto non-publicly traded participants, and, if shareholders are permitted to cooperate, the end of competition with other public firms.

Corporate law determines corporate decisionmakers and, along with larger market forces, helps determine the weight they give to the claims of the varying corporate constituents. Balancing the sometimes contradictory goals of corporate law — autonomy for investors, job security for employees, growth for the economy, respect for the environment, innovation and efficiency for consumers, ability to innovate, streamlined
decisionmaking processes, internal consideration of multiple social values, ability to deviate from governmental dictats, self-governance and dignity for employees, responsiveness to consumers — is a central task of any political system. That part of the task that we have delegated to Delaware is, in our system, beyond the control of political debate and normal representative democracy: we (at least most of us) don’t vote for the Delaware legislature.

In short, Delaware is taxing and governing the entire nation. Republican, democratic and federalist values incorporated in the Constitution and our political culture ought to make us deeply suspicious of this state of affairs. Can it be justified?

III. THE INTERNAL AFFAIRS DOCTRINE: FROM CHOICE OF LAW TO LAWLESSNESS

The Internal Affairs Doctrine is the core of Delaware’s dominance. The doctrine holds that the “internal affairs” of a corporation are governed by the law of the state in which the corporation is incorporated, regardless of where the corporation is in fact located or where the transaction at issue took place. Internal affairs, in the first instance, can be defined as meaning those things that are usually dealt with in the Business Corporations law of the incorporating state.

Under the Doctrine, if for example a New York court is asked to adjudicate a dispute concerning the “internal affairs” of a corporation incorporated in Delaware, it will apply the law of Delaware, even if the corporation has its headquarters and all its operations in New York, holds all corporate meetings (including shareholders meetings and directors meetings) in its New York headquarters, all the employees, stockholders, directors and other significant participants live and work in New York, all the relevant records are in New York, all the relevant agreements were made in New York and all the disputes occurred in New York.

In some form or other, the Internal Affairs Doctrine is accepted common law in every state and embodied in statute in most. The R.M.B.C.A. reaches this result by defining “corporation” to exclude “foreign corporation” and defining “foreign corporation” to mean “a corporation for profit incorporated under a law other than the law of this state.” The effect of these definitions is that every corporation incorporated in the enacting state is covered by that state’s R.M.B.C.A. regardless of whether it is located or doing business there; conversely, all corporations incorporated elsewhere, regardless of whether they are located or doing business in the enacting state are foreign corporations not subject to the enacting state’s R.M.B.C.A.. The issue of the reach of the doctrine is also

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5R.M.B.C.A. 1.40(4). The R.M.B.C.A. has been enacted more or less verbatim in a number of states and is closely followed in others. See, e.g., Utah Statutes Annotated 16-10a-101 et seq. (Utah Revised Business Corporations Code) (text of Utah statute closely parallels R.M.B.C.A.). The Uniform Limited Liability Act has almost precisely parallel structure: each LLC is regulated by the law of the state in which its principals choose to organize.

6R.M.B.C.A. 1.40(10).
clear, at least as to states that have enacted the R.M.B.C.A. or its equivalent: an “internal affair” is an issue that is dealt with by the R.M.B.C.A..

Other statutes differ at least in form from the R.M.B.C.A.. Thus, New York makes a similar distinction between domestic and foreign corporations, based on the state of incorporation rather than, for example, where the firm is located or does business or the citizenship of its human participants:

(4) “Corporation” or "domestic corporation" means a corporation for profit formed under this chapter, or existing on its effective date and theretofore formed under any other general statute or by any special act of this state for a purpose or purposes for which a corporation may be formed under this chapter, other than a corporation which may be formed under the cooperative corporations law.

... (7) "Foreign corporation" means a corporation for profit formed under laws other than the statutes of this state, which has as its purpose or among its purposes a purpose for which a corporation may be formed under this chapter, other than a corporation which, if it were to be formed currently under the laws of this state, could not be formed under this chapter. 7

New York then asserts the right to legislate with respect to foreign corporations:

This chapter [i.e., the N.Y.B.C.L.] applies to every domestic corporation and to every foreign corporation which is authorized or does business in this state. 8

Having asserted the right to regulate, however, New York doesn’t do so: most provisions of the N.Y.B.C.L. apply only to “corporations” defined as corporations organized under the statute. Even where the language could be interpreted otherwise, New York courts consistently refer to the Internal Affairs Doctrine. For example, section 626 of the N.Y.B.C.L. explicitly authorizes derivative actions with respect to foreign corporations, but most New York courts view this as a jurisdictional grant that does not affect the choice of law question. 9

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9 See, e.g., Pessin v. Chris Craft, 586 N.Y.S.2d 584 (1992) (acknowledging the Doctrine while applying New York law to the question of whether shareholders of a Delaware corporation acquired their shares by operation of law in order to allow them to bring a derivative action under N.Y.B.C.L. 626, which explicitly refers to foreign corporations); Miller v. Scheneyer, 606 N.Y.S. 2d 642 (applying Delaware law to determine demand requirements in a derivative action, despite the explicit language of N.Y.B.C.L. 626 authorizing derivative actions with respect to foreign corporations); Hart v. General Motors Corp., 517 N.Y.S.2d 490 (1987) (discussing the “fundamental” principle of the Internal Affairs Doctrine); Tarlow v. Archbell, 47 N.Y.S.2d 3 (N.Y. Sup. 1943) (holding that derivative action claiming that directors breached duty to corporation is not an internal affair and applying New York law to demand requirement); Miller v Quincy, 72 N.E. 116 (N.Y. 1904) (holding that a derivative action against directors of a foreign corporation doing business in New York may be maintained in New York, in part out of fear that no other court would have personal jurisdiction over the directors, and rejecting the Internal Affairs Doctrine – understood as a jurisdictional limitation, not a choice of law principle – as to actions that injure a citizen of New York).
No American state requires that corporations have more than a purely formal presence in the state in order to incorporate there. The R.M.B.C.A. is again typical:

Each corporation must continuously maintain in this state:

(a) a registered office; and
(b) a registered agent, who may be:
   (i) an individual who resides in this state and whose business office is identical with the registered office;
   (ii) a domestic corporation or domestic not-for-profit corporation whose business office is identical with the registered office;
   (iii) a foreign corporation or foreign not-for-profit corporation authorized to transact business in this state whose business office is identical with the registered office.\(^{10}\)

There is no requirement that the registered office be a place where the corporation does business; the usual understanding is that it is merely a place where the corporation can be served with process. Similarly, the registered agent need not be an employee or otherwise connected with the corporation; it is simply a person or institution authorized to receive process. Indeed, it is often a company that provides this service for many corporations that are otherwise entirely out of state.

Delaware makes completely clear the lack of any nexus requirement in its General Corporation Law:

Any person, partnership, association or corporation, singly or jointly with others, and without regard to her or her or their residence, domicile or state of incorporation, may incorporate or organize a corporation under this chapter ...\(^{11}\)

In short, so long as the corporation appoints an agent for service of process in the state where it is incorporated, it need not have any office, transact any business or otherwise have any presence there.

The Internal Affairs Doctrine, thus, is a radical departure from ordinary choice of law rules. Consider the case where the suit is brought in the incorporating state (Delaware, for example). Under the usual doctrines, appointing an agent for service of process probably would be deemed consent to personal jurisdiction in the state of incorporation.\(^{12}\) Accordingly, Delaware would certainly be able to hear the suit. Whether it could apply Delaware law, however, would be a question of the type of dispute. In a tort or property dispute, or in a contract dispute in the absence of an explicit choice of law clause, ordinary

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\(^{10}\)R.M.B.C.A. §5.01.


\(^{12}\)Case (holding that defense of lack of personal jurisdiction is waivable); see also CASE (holding that service upon defendant or defendant’s agent for this purpose is sufficient to create personal jurisdiction even in the absence of other contacts). But see CASE (holding that service upon defendant whose only contact with state was brief physical presence there is insufficient to create personal jurisdiction).
choice of law rules would direct the forum state not to apply its own law where the dispute, parties and relevant agreements were all located or had arisen elsewhere. Rather, the forum state ought to apply the law of the state that has the strongest interest in the dispute. In the usual course, courts would consider factors such as where the dispute arose, where the agreements were made, which state’s citizens will be most impacted by the issue, where the parties are domiciled, and so on.

In a case where the corporation’s only contact with Delaware is that it incorporated there (and the statutorily required registered office and agent), none of these factors would point to Delaware. On the contrary, Delaware would be viewed as having no interest whatsoever in applying its own law to a dispute the consequences of which are felt somewhere else. Ordinary choice of law doctrine would, rather, direct Delaware to apply the law of the state with the strongest interest in applying its law. Typically, this would require determining the domiciles of the parties and their location at the time of the dispute. Thus, a court might ask where the corporation is located (as European courts do in corporate choice of law disputes). It might ask where the human parties are located — managers and shareholders, for example, if it understood the dispute as corporate law scholars typically do as a struggle between those two groups. It might ask where the dispute arose — where the relevant agreements were made (where the bylaws or articles of incorporation were negotiated or enacted, for example). It might ask, as courts typically do in tort cases, which state’s economy was likely to be impacted by the results of the litigation - which

In a typical corporate law dispute, if the court understood the issue to be a dispute between managers and shareholders, it might look first to the location of those human parties, or the location of the corporation itself, or ordinary choice of law doctrine regarding, for example, the location of the contracts or wrongs in dispute. [Can I be more specific here?]. Conversely, were the state filed in a state with an actual connection to the dispute, for example the state in which the corporation operates (New York in the fact scenario postulated above), ordinary doctrine would direct it to apply its own law.

Under the Internal Affairs Doctrine as currently understood, however, none of these issues are relevant. The doctrine simply states that the state where the litigation takes place should apply the law of the state where the corporation is incorporated, regardless of the contacts with the host state or any other ordinary choice of law issues.

{"One way to understand this is to take corporations to be a form of contract, and the decision to incorporate in Delaware to be an implicit choice of law clause. But this cannot be enough to reconcile internal affairs with ordinary choice of law doctrine: corporate law has too many obviously non-contractual aspects. Neither tort victims nor environmental regulators ______ to Delaware law of limited liabilities even in a “consent.”}
In the beginning, the Internal Affairs Doctrine was not so dramatic a departure from conflicts rules. The early cases treat Internal Affairs as primarily a jurisdictional issue. In the early nineteenth century, the problem had been understood as one of sovereign immunity. The notion was that even a private business corporation is a “body politic”: a “political person” created by a particular sovereign for a public purpose that should be understood as a delegation of that legislature’s sovereignty. In Kyd, the leading English treatise on corporations at the beginning of the century, civil corporations are typically municipalities or guilds; equivalents to the modern business corporation are virtually absent. This, of course, reflected the economic reality: virtually all corporations were either churches, universities or at least quasi-governmental. Even early business corporations - banks, insurance companies, highway and bridge companies, later canal companies - were understood as performing quasi-governmental and clearly public functions.

To be sure, in the famous case of Dartmouth College v. Woodward, Chief Justice Marshall stated that a corporation “is no more a state instrument, than a natural person, exercising the same powers, would be.” Still, his disclaimer seems to have been motivated by a thought that perhaps corporations were somewhat state-like. Indeed, the doctrines and standard hornbooks allowed doctrine to wander from private to municipal corporations freely: Angell and Ames, for example, use examples of the “court of common council in London” and the “court of proprietors of the Bank of England” interchangeably in discussing the composition and membership of private, non-municipal corporations.

State courts continued, even after Dartmouth College, to think of even business corporations as state-like and public. As an Illinois judge, echoing a common suspicion of the great railroads, wrote it in 1883:

They [corporations] were created as governmental agencies or instruments, to aid in the accomplishment of the purposes for which government was organized. They are employed as governmental instruments to carry out enterprises which government is not adapted to accomplish. They combine the capital, energy and prudence of individuals, with the prospect of individual gain in the furtherance of the public interest and general welfare. Corporations are never created simply for private gain. Their nature is, inherently, a monopoly, combining capital and power detrimental to private enterprise, and when they become injurious to, or cease to promote, the public interest, they must be controlled or extinguished. They must never become to the States what the ancient barons were to the British government,— not only uncontrollable by, but more powerful than the government, levying tribute upon all who came within their power,—unless we are prepared to surrender our liberties.

131 STEWARD KYD, A TREATISE ON CORPORATIONS 13 (“body politic”), 14 (“political person”); 28 (describing civil corporations as created “for the maintenance and regulation of some particular object of public policy”) (1793, facsimile edition 1978).

14See generally, STEWARD KYD, A TREATISE ON CORPORATIONS.


Charters to corporations are granted upon a consideration rendered or to be rendered; and that consideration is, that they will assist, within the scope of their power and within the purposes of their organization, to accomplish the purposes for which government was organized. When they cease to answer that purpose the consideration fails, and when they become instruments of oppression they must and will be controlled.

If they shall be uncontrolled, we must expect to see their power and oppression increase to destructive lengths. The history of the East India Company illustrates the growth and abuse of irresponsible corporate power. From a small beginning it grew to be an instrument of oppression never surpassed in the world's history. All uncontrolled power is sure to be abused, and it increases with great rapidity, as illustrated by the East India Company, and the abbeys of England. Wholesome restraint is absolutely indispensable, or the people must be oppressed to the extent of the power of extortion possessed by these bodies, and the extent of the oppression is commensurate with their power. 17

Note the variety of governmental and powerful, threatening images: corporations are instruments of government, of monopoly, (conspiratorial?) combinations, dangerous in the same way as are governments, threatening to become independent power sources like the “ancient barons.” 18 On another well known view, the ancient barons are the source of Magna Carta, but to this state supreme court justice, they appear less as restraints on an overweening King John then as oppressors of the peasants who must look to the king for protection against their more immediate lords. In any event, he certainly does not portray corporations as private citizens with natural rights that must be protected against invasion by the state: in the great state/citizen divide of liberal politics, they remain state-like.

On this corporations-as-state view, corporate bylaws were analogized not to contract but to legislation, understood to be binding on shareholders because the legislature had granted “a limited legislative power” or a “power of qualified legislation” to the corporation to govern its internal affairs. 18 By-laws, say Angell and Ames, citing Kyd and Kent, “are considered as private statutes for the governance of the corporate body.” 19 Similarly, in explaining why a corporation’s bylaws must conform to the general law, Angell and Ames do not - as we probably would - simply analogize the corporation to an ordinary citizen who must obey the law, but instead see the issue as one of delegation to a lesser sovereign: “neither a state, nor the general government, can grant legislative power greater than they possess themselves.” 20

If internal corporate governance was a delegation from the state, corporations were authorized for basically public purposes, 21 and bylaws were a form of legislation – an

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1Wabash, St. L., & P. Ry. Co. v. People, 105 Ill. 236 (1883) (separate opinion of J. Walker)
2Tuttle v. Walton, 1 Ga. 43 (1849) at *2 (argument of counsel), *8 (court’s opinion).
3ANGELL & AMES, supra. n. 16 at 65, 267, 271 (describing the power to make by-laws as “legislative”).
4ANGELL & AMES, supra. n. 16 at 274.
5See, e.g., Thompson v. Waters, 25 Mich. 214, *3 (Mich. 1872) (stating that states authorize corporations because the “creation and prosperous continuance of such corporations were supposed to be objects of public interest, which deserve to be fostered”).
“extraordinary power”\(^{22}\) – then business corporations (like their close relatives municipal corporations) were at least quasi-governmental.\(^ {23}\) Accordingly, a form of sovereign immunity should lead other jurisdictions to decline to adjudicate internal disputes, much as they would decline to adjudicate internal disputes between a foreign sovereign and its subjects. As a 1904 New York court put it:

If the illegal acts of the directors or of the corporation offended solely against the majesty of the state to which it owed its life— in other words, constituted only public wrongs—the proposition is probably correct, for we are not compelled to, nor should we, entertain actions simply to redress the outraged dignity of foreign governments.\(^ {24}\)

But this early understanding was ultimately abandoned due to two weaknesses. First, after the wave of general incorporation statutes in the mid-nineteenth century, it was harder to understand corporations as part of the sovereign. Though they still required permission of the state to be created, corporations no longer seemed so obviously public and governmental in their essence as the states largely abdicated control over their details and purposes. Relatedly, especially after the passage of the Civil Rights Amendments, railroads and other large corporations began to find it advantageous to present themselves as private, non-governmental entities (or “persons”) entitled to invoke constitutional rights against potential regulators.\(^ {25}\) Under the older view, a corporation was a mere emanation of the sovereign that created it suggesting that sovereign (at least) should have full power to control it: surely the state is entitled to regulate itself.\(^ {26}\) On the other hand, as corporations succeeded in reclassifying themselves as private persons, they seemed entitled to invoke the rights of individuals against the state. The new national corporations sought to avoid the old views that corporate charters were sovereign acts “restrictive of private right,”\(^ {27}\) and instead to be

\(^{22}\) Tuttle v. Walton, supra n. 18 at *8 (“... the exercise of the extraordinary powers of legislation by Corporations, in the enactment of By- laws”). Interestingly, the Tuttle court does not distinguish between this view of bylaws as “legislation” and a view of them as “contracts” (id.), even though contracts (unlike legislation) require explicit consent of each bound party, not merely a majority. This confusion continues to characterize modern metaphors of corporate law.

\(^{23}\) The rhetoric of state sovereignty did not die quickly or completely, nor was it confined to the jurisdictional issue. In 1885, Mississippi defended railroad price control regulations against a Federal commerce clause attack on the ground that the railroad, a Mississippi corporation, because “The right to compensation is an essential attribute of such a corporation ... Prescribing rates is providing for the existence of the artificial being. It is breathing into it the breath of life, that it may become a living being. The power to do this belongs to the sovereignty that may create corporations and shape their being and define their functions. ... If [the State] may create such corporations it may determine their attributes and prescribe what they may charge for services rendered, as well as the other conditions of their existence.” Stone v. Yazoo & M.V.R. Co., 62 Miss. 607 (1885).

\(^{24}\) Miller v. Quincy, 72 N.E. 116, 118 (N.Y. 1904).

\(^{25}\) See, e.g., JAMES ELY, RAILROADS AND AMERICAN LAW 18 (2002) (discussing ultimately successful attempt of railroad companies to persuade courts and legislatures to see them as private, beginning even before the Civil War).

\(^{26}\) For a modern echo of this view, see J. Rehnquist’s dissent in First National v. Bellotti (arguing that because the state created corporations, it can regulate them).

\(^{27}\) See, e.g., Beaty v. Knowler, 29 U.S. (4 Pet.) 152, 167 (holding that because “the exercise of the corporate franchise, being restrictive of individual rights, cannot be extended beyond the letter and spirit of the act of incorporation,” a land-owning corporation had no authority to assess real estate taxes on its members).
seen as embodying private right itself. In the great liberal divide between public and private, government and civil society, corporations sought to be classified as private and non-governmental. *Santa Clara* dramatically upheld this position, allowing corporations to claim the protection of the Fourteenth Amendment as if they were individuals in need of protection against an overweening state. But a private corporation seen as a person existing independent of the state surely could not be entitled to the protections of sovereign immunity.

(This shift, I think, reflects more a change in metaphor than any underlying privatization of corporations – indeed, the general railroad incorporation laws typically granted railroads the extraordinarily intrusive and deeply governmental power of eminent domain. In the new atmosphere, however, governmental powers didn’t necessarily suggest governmental status.)

Together with the shift in understanding of business corporations as more distinctly private, mid- and late-nineteenth century lawyers began abandoning the older “aggregate” understanding of the corporation. In the earlier cases, the United States Supreme Court allowed corporations to sue in the Federal Courts under diversity jurisdiction when the shareholder-members of the firm were all from a state other than the state of the opposing party. That is, the courts simply looked through the corporation and determined its citizenship by looking to the citizenship of its members. With the rise of the great railroad companies, however, this doctrine would have excluded national corporations from the national courts; the federal courts obligingly changed the doctrine. The new rule characterized a corporation as a “person” rather than an collective made up of citizens, and determined the corporation’s personal citizenship without relation to the citizenship of the human beings who compose it. Instead, a corporation was simply deemed to be a citizen (for diversity purposes but not for many other privileges of citizenship) of the state which had incorporated it. While this

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29ELY at 35ff. (pointing out that courts routinely upheld eminent domain powers on ground that railroad building was a public purpose even if the railroads were private).
30Bank of United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809). In *Deveaux*, the Supreme Court held that corporations are not citizens, at 85, but diversity jurisdiction should be determined as if the corporation had no independent existence but were a “company of individuals” (at 85) or a “name” (at 86) for its members suing collectively. (This view continues to influence corporate speech doctrine, which resolutely pretends that corporations are nothing more than voluntary associations of citizens similar to a Committee of Correspondence. See, Greenwood (Iowa).)
31Louisville Rwy v. Letson, 43 U.S. (2 How.) 497, 555, 557 (1844) (“a corporation created by a state ... seems to us to be a person, though an artificial one, inhabiting and belonging to that state, and therefore entitled, for the purpose of suing and being sued, to be deemed a citizen of that state”). Of course, corporations are not citizens for other purposes, such as voting or apportionment, so the textual basis of this doctrine is weak at best. See, e.g., Marshall v. B&O, 57 U.S. (16 How.) 314 (1853), dissenting opinion of Daniel, J, at 338.

In the years following *Letson*, the Court continued to waver in its theory of jurisdiction, although it consistently provided a federal forum for suits involving corporations. Thus, in Marshall v. B&O, 57 U.S. (16 How.) 314 (1853), it based jurisdiction on the presumed “residence” of the “members” of the corporation, arguing that since a corporation rarely could
be sued anywhere but in its state of incorporation, its members were estopped from claiming residence elsewhere. This presumption, like the *Letson* claim that a corporation must be located where it is incorporated may have had some connection to reality in 1853, see DODD, supra n. 53, at 153, but lasted as a legal matter long after it became quite pure fiction. (Prof. Dodd states that in 1853, there were several prominent corporations with ownership and directors in one state and factory in a different one, but few examples of the modern phenomenon of incorporation in a state with which the firm has no business connection at all).

I have not found any American case which has taken the *Letson* rule to require any inquiry into the actual "residence" of the corporation: it has been understood to refer to its state of incorporation, not the location of its operations. (In contrast, the civil law developed elaborate doctrines to determine the location of a corporation, recognizing that a firm may be located in one place and incorporated in another). *Buseck*, Northern Indiana RR v. Michigan Central RR, 56 U.S. (15 How.) 233, 249 (1853) (Catron, J. dissenting) (arguing for a rule like the civilian Siege Real rule, on the ground that it would be unfair to allow a corporation owned and operated in one state to sue its neighbors in Federal court merely because it was incorporated elsewhere).

Similarly, it appears that each time the reigning theory of jurisdiction would have excluded federal jurisdiction, the Court changed theories. Thus, the *Deveaux* theory of looking through the corporation was not enough to bar a suit against a corporation entirely owned by a state. Bank of Kentucky v. Wister, 27 U.S. (2 Pet.) 318 (1829). Once shareholders began to be more diverse, so that the *Deveaux* theory would have regularly precluded jurisdiction, the Court began to presume that shareholders were located in the state of incorporation. *Letson, Marshall*. But when that presumption would have defeated jurisdiction — in a suit against an Ohio corporation by its Connecticut shareholder, the Court didn’t apply it. Doctor v. Harrington, 196 U.S. 579 (1905).

Thus, on the question of federal diversity jurisdiction, results seem to have driven theories: the principle seems to have been that national corporations were to have access to national courts, regardless of doctrine. Nonetheless, by mid-century, both *Deveaux* look-through-the-corporation theories and *Letson* personhood theories agree in seeing the corporation as fundamentally private and separate from the state.

In the mid-nineteenth century, the phrase “internal affairs” appears mainly in cases concerning the powers of municipal corporations to govern their “internal affairs” and in particular whether that authority extended to various public works, see e.g., East Tennessee University v. City of Knoxville, 65 Tenn. 166 (Tenn. 1873); City of Elk Point v. Vaughn, 46 N.W. 577 (Dakota.Terr. 1875); Sharpless v. Mayor of Philadelphia, 21 Pa. 147 (1853); Louisiana State Bank v. Orleans Nav., 3 La. Ann. 294 (1848), or investing in securities of railroads, or other new municipal powers, see, e.g., Alcorn v. Hamer, 38 Miss. 652 (1860). The phrase doesn’t appear in Angell & Ames’ index. ANGELL & Ames.
clear that foreign corporations could be sued in its courts, and similar statutes appear in other 19th century codes of civil procedure.\textsuperscript{33}

Under the special incorporation regime, the powers of corporations were a function of the particular details of the specific statute creating them, rather than general statewide policies. Since there were no general policies, there was no reason for courts to worry about whether another state’s policies might be different than its own. Moreover, since corporate powers were specific and limited, most litigation was over whether specific acts were ultra vires, even when we might litigate similar issues under other

\textsuperscript{33}N.Y.B.C.L. 1314, derived from a 1920 amendment to the Gen. Corp. Law, in turn derived from Code Civ. Proc. 1780, enacted in 1849 and amended in 1880. The original text appears in New York Law 1849, ch. 107 “An Act to extend the remedies at law against foreign insurance companies”. Despite the title, the Act is not limited to insurance companies. Rather, it permits suits “against any corporations created by or under the laws of any other state, government or country, for the recovery of any debt or damages, whether liquidated or not, arising upon any contract made, executed or delivered, within this state, or upon any cause of action arising therein...” Thus, even before the widespread rise of out-of-state corporations, New York had abolished the original form of the Internal Affairs Doctrine. See, Howell v. Chicago & NW, 51 Barb. 378 (N.Y. Sup. 1868) (“Previous to the Code, foreign corporations were not the subject of litigation in the courts of this state, except when proceeded against by attachment of their property for the collection of a debt or the redress of a wrong”). Howell’s limiting construction of the statute (restricting jurisdiction to clear wrongs) is rejected in Prouty v. Michigan S&N RR Co., 1 Hun 655, 658 (1st Dept 1874), but it continued to be influential, see e.g, North State Copper & Gold Min. Co. v. Field, 64 Md. 151, 20 A. 1039, 1040 (1885) (citing Howell in support of view that court should refuse jurisdiction in case involving the internal affairs of foreign corporation); Condon v. Mutual Reserve Fund Life Ass'n, 42 A. 944 (Md. 1899) (citing Field to bar subject matter jurisdiction over dispute regarding terms of mutual insurance); Madden v. Penn Electric Light Co., 37 A. 817 (Pa. 1897) (following Field); Taylor v. Mutual Reserve Fund Life Ass'n of New York, 33 S.E. 385 (Va. 1899) (following Field and stating that court had no subject matter jurisdiction to adjudicate mutual insurance dispute, because it was internal affair of foreign corporation. Jurisdictional statute did not change this rule, because “Courts other than those of the state creating it, and in which it has its habitat, have no visitorial powers over such corporation, have no authority to remove its officers, or to punish them for misconduct committed in the state which created it, nor to enforce a forfeiture of its charter. Neither have they the power to compel obedience to their orders nor to enforce their decrees.”). Cf. North Carolina Civ. Proc. 194 (similar) (discussed in Howard v. Mutual Reserve Fund Life Ass’n, 34 S.E. 199 (N.C. 1899)). [[Prouty v. Mich. Southern R. R., 1 Hun 655, 4 T. & C. 230, CONTRA, Williston v. Mich. Southern R. R., 13 Allen 400.]]

An injunction to restrain a foreign corporation from using the proceeds of an issue of stock, alleged to be illegal and void, and appointing a receiver of such proceeds, was allowed in New York at the suit of stockholders residing in New York, Fisk v. Chicago R. R. Co., 53 Barb. 513, 4 Abb. Pr. (N. S.) 378.

Under the New York code, an action brought by non-resident and resident stockholders against a foreign corporation for an account, and to set aside as void a purchase of another corporation’s property by the defendants, was dismissed as to the non-resident plaintiffs, and sustained as to the residents, Ervin v. Oregon R. R. Co., 28 Hun 269, 35 Hun 544. (following Field). Thus it bars them from regulating the corporation out of state or purporting to “annul or forfeit” its charter, nonetheless, a receiver of the corporation’s in-state property may be appointed and may control that property on behalf of the corporation’s in-state creditors and stockholders. See, e.g., Minchin v. Second Nat. Bank of Paterson, 36 N.J. Eq. 436 (1883). Note that the Minchin court (at least in dicta) sees no problem in applying N.J. law to protect a N.J. shareholder of a N.Y. corporation: the issue is still seen as one of jurisdiction rather than choice of law.
doctrinal labels. Since the 19th century view was that the problem was one of jurisdiction, rather than choice of law, once courts were satisfied that they had jurisdiction, they seem to regard the choice of law issue as obvious or trivial. Thus, in Prouty v. Railroad Co. and several cases following it, New York specifically rejected the view that it lacked jurisdiction to hear an action on behalf of a New York preferred stock holder against a corporation created under the law of another state, based on the New York statute discussed above. The issue before it was whether the corporation was obligated to pay dividends on preferred stock; the corporation defended on the ground that the issuance of the preferred stock was ultra vires and hence illegal. The court simply reads the incorporating statutes, concludes based on the statutory language that the stock issuance was authorized and then ordered the foreign corporation to issue the dividends. The court views the issue as one of jurisdiction: New York’s writ extends only to directors and assets of the company that are located in New York - but with that limitation, the court uses its equity powers to order a foreign corporation to issue a preferred stock dividend. The old view that a court had no power of visitation over a foreign corporation is dead.

By the 1880s, we see New York decisions invoking something like the modern internal affairs doctrine (although not in so many words), and often still cloaked in jurisdictional terms. Consider Ives v. Smith, dating from 1888. The court continues to see the issue as largely jurisdictional, and the bulk of the relevant discussion in the opinion is devoted to parsing the Prouty line of decisions:

Of course, it is not to be understood that, even under the wide interpretation given to section 1780 of the Code, the courts of this state would exercise jurisdiction of every kind of action or suit brought by a resident against a foreign corporation; for where only the mere internal affairs of the corporation, resting in the untrammeled discretion of its directors as its governing or controlling

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34Prouty v. M. S. & N. I. R. R. Co., 1 Hun 655, 658 (1st Dept. 1874)[note to editor: this reporter does not appear in Lexis or Westlaw; my library supplied a copy]; appeal den. 52 N.Y. 363, (allowing, in original action by a New York preferred shareholder against a foreign corporation, a judgment enforced against property or directors located in New York ordering foreign corporation to declare and pay preferred dividend). Prouty was followed by Boardman v. Lake Shore & M.S. Ry. Co., 84 N.Y. 157 (1881) (New York court interpreted rights of preferred stock issued by railroad incorporated elsewhere and required the corporation to issue preferred dividends and refrain from issuing common dividends, citing only New York law). In Boardman, almost exactly as in Prouty, a foreign railroad (with its headquarters in New York but its operations elsewhere) allegedly violated the terms of its preferred stock. Later, the foreign railroad merged its lines with a New York railroad, and (as was the practice at the time) the merged line was incorporated in each of the states in which it operated. The New York court applied New York law to interpret the preferred stock and directed the foreign corporation to pay its dividend.

35Ives v. Smith, 3 N.Y.S. 645 (1888). Ives appears to be a derivative action on behalf of an Oregon corporation, brought largely by New York shareholders against directors of the corporation resident in New York to enjoin the directors from proceeding with planned investments on behalf of the corporation. The Ives court views the issue before it as one of the corporation’s “contracts”; “The subject-matter of the controversy is the contracts and obligations of the defendant corporation, and there is a fund within the jurisdiction of the court, the use of which, in violation of the contracts, may be effectually enjoined, if, upon the whole case, the court shall find that the contemplated use is contrary to the duty of the directors, and would cause irreparable injury.” But there is no doubt that modern doctrine would view an action by a shareholder to enforce a “duty of the directors,” however clear that duty might be, as an “internal affair” governed by the law of the state of incorporation.
agents are involved, or where the remedy sought can only be given by the courts of the sovereignty by which the corporation was created, or where a decree would be abortive, jurisdiction would be declined. ...

[T]he rule deducible from the cases is that the courts of this state will entertain actions against foreign corporations, in favor of resident plaintiffs, not only to recover at law, but also in equity, including suits in favor of resident shareholders, who have clear rights to be protected; and they will compel the enforcement, by officers and directors of foreign corporations, if properly brought into court, of the contract obligations of the corporation, if the neglect or violation of such contract obligations amounts to a breach of trust or duty which will be productive of injury to such resident shareholders, in matters removed from the ordinary powers or discretion of such directors, and no adequate remedy at law is available.36

Based on this understanding of the law, the Ives court then proceeds to hear and decide an action by shareholders of an Oregon corporation seeking to enjoin the directors of their corporation from proceeding with a planned investment (in Oregon). For the Ives the difficult issue is one of authority and jurisdiction, not choice of law. Although the court might, as it indicates, decline jurisdiction if only “mere internal affairs” are involved, apparently the reference is to the general doctrine that courts should not intervene in the discretion of directors - what is now known as the business judgment rule. This is made clear in its subsequent discussion of the leading cases on the scope of equity jurisdiction on behalf of dissatisfied shareholders - which involve not the question of whether any court ought to intervene, not which court or which law ought to apply.37 That is, if the directors are within their discretion, not only the New York court but every court should decline jurisdiction. Where shareholder rights are “clear,” New York can intervene, even though the corporation is incorporated elsewhere. Thus far, the Ives court follows the earlier ones, viewing the issue solely as one of authority. As in Prouty, Ives assumes - without explanation - that the Oregon authorizing statute would decide the issue before it. Here we see the beginnings of the modern view, without any clear justification.

Another 1888 New York case, however, views the issue differently.

“The plaintiff alleges in his complaint certain facts which he claims entitle him to relief, as against the said defendant the New York Iron Mine [a Michigan corporation doing business in New York]. The relief that he claims against this defendant is that it be decreed to declare and pay such dividends as may appear upon an accounting to be proper. The case of Fisher v. Insurance Co., 52 N. Y. Super. Ct. 179, is a conclusive authority in favor of this demurrer. It was there held that the courts of this state will not interfere with the internal administration of the affairs of a foreign corporation, that the law does not give any remedy here for the things complained of, and, therefore, that the court has no jurisdiction of the subject of the action. This demurrer of the defendant the New York Iron Mine is sustained.”38

36Ives v. Smith, 3 N.Y.S. 645 (1888).
37See, e.g., Dodge v. Woolsey, 59 U.S. 331 (Mem) (1855).
Here, the issue is still jurisdictional (a New York court will not adjudicate the issue) rather than one of choice of law (in adjudicating, the New York court should apply the law of the state of incorporation). However, while the Prouty line of cases sees the jurisdictional issue as one of power over the persons and property involved, these cases chose not to adjudicate even though the defendants seem clearly present and subject to the court’s coercion. Although the court’s reasoning is unclear, this analytically separate version of the internal affairs doctrine, focusing on subject matter jurisdiction, seems related to a different view that appears early on.

As late as the 1870s, the general black letter law was that a corporation had no existence outside of the state which incorporated it:

“No State has the power to create corporations, or to regulate their powers, or to authorize the exercise of corporate franchises, in other States. ... A corporation ... is but an artificial person, whose strictly legal existence, by force of obligatory law, is confined to the State which has created it and endowed it with its powers, capacities and rights; and it can only exercise those powers, capacities and rights in another State, by the permission, express or implied, of the sovereign or legislative power of the latter.”

In the view of some courts, it was simply inconceivable that a foreign corporation could have legal personality - sue or be sued:

If it is true as held by the court in the case in 1 Black--that a corporation, a legal entity which exists by force of law, can have no existence beyond the limits of the State or sovereignty which brings it into life and endows it with facilities and powers, and that it cannot migrate, then, unless it exists by force of law outside of the State which gave it birth, it can be sued only in the State which brought it forth. It is not like a natural person enabled to travel on its own responsibility from county to county and from State to State, and liable to be sued in any transitory action, wherever found. But it may have a being elsewhere, in another State, if given a status there by force of law. The State, which gave it birth, can give it no power to travel beyond the limit of that State, and can give it no rights or privileges away from home; and if no other State could adopt the child as its own, and confer powers and capacities upon it, and nurture it, there could be no help for it outside of its own State, and there it would have to remain, and could do no business elsewhere, and could sue and be sued nowhere else.

Indeed, that court went so far as to contend that even the consent of the defendant corporation - extracted perhaps as a condition of doing business in the state - would not suffice to give the court jurisdiction over a foreign corporation. Only because the corporation was also chartered domestically could it be sued.

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39 Thompson v. Waters, 25 Mich. 214, *3 (Mich. 1872). See also, Ohio & M.R. Co. v. Wheeler, 66 U.S. 286 (1861) (Discussing the legal status of a railroad that had corporate charters from two states, C.J. Taney contended, “Yet it has no legal existence in either State except by the law of the State. And neither State could confer on it a corporate existence in the other, nor add to or diminish the powers to be there exercised. It may indeed be composed of and represent under the corporate name the same natural persons; but the legal person or entity, or persons which exist by force of law, can have no existence beyond the limits of the State or sovereignty, which brings it into life and endows it with its faculties and powers.”).

40 Baltimore & O. R. Co. v. Pittsburg, W. & K. R. Co., 17 W.Va. 812 (1881). That court eliminates the problem in the case before it by concluding that the B&O had also been chartered in Virginia (and hence West Virginia) and was therefore also a domestic W. Va. corporation.
In this contrasting view, courts should decline to intervene in the internal affairs of a foreign corporation not out of respect for the foreign sovereign but because they “possess no visitorial power” over a foreign corporation.\footnote{See, e.g., Howell v. Chicago & NW, 51 Barb. 378 (N.Y. Sup. 1868) (dispute over allegedly improper dividend policy of foreign corporation operating out-of-state railroad should not be adjudicated by New York court of equity because court has no power to remove the directors from office or revoke the corporation’s charter and therefore litigation in New York would likely prove useless); The Cumberland Coal Company v. The Hoffman Coal Company, 30 Barb. 159, 171 (N.Y. Sup. 1859) (“Foreign corporations may, in some instances, sue or be sued in our courts, but to warrant the proceeding, there must be either a necessity or a fitness suggested by the peculiar circumstances. The cause of action, or the subject, or at least some property to be acted upon, must have arisen or be situated within our jurisdiction. Without these qualifications, or one of them, the judgment, should the court render it, would be a nullity. It would operate on nothing in the state, and be regarded by nothing out of it.”).} The problem again is understood largely in jurisdictional terms rather than choice of law terms: were the court to declare that a foreign corporation had acted improperly, it would have no way of enforcing its judgment.\footnote{E.g., Post v. Toledo, C. & St. L.R. Co., 144 Mass. 341, 11 N.E. 540, 546 (1887) (stating that Massachusetts court would decline to adjudicate dispute regarding internal affairs of foreign corporation “because it is a suit against a foreign corporation which involves the relation between it and its stockholders, and in which complete justice only can be done by the courts of the jurisdiction where the corporation was created”).} Similarly, a legislature which purported to regulate the internal affairs of a foreign corporation would be acting outside its sphere: “The laws of the state do not have extraterritorial force. It would be meaningless for this state to try to legislate upon the internal affairs of such foreign corporations, and it has not attempted to do so.”\footnote{Miles v. Woodward, 46 P. 1076 (Cal. 1896). Note that Miles, like the modern cases, simply fails to consider the possibility that it might be the foreign legislature - creating a corporation and sending it abroad - which is acting extraterritorially. This is a dramatic shift from the earlier cases.} (Apparently, there was no expectation that the courts of the incorporating state would treat the adjudicating state’s judgment as binding under doctrines of comity or full faith and credit).

Since the analysis is largely in terms of the court’s capacities, courts created exceptions where non-corporate law doctrine gave courts greater powers. For example, where a New Jersey corporation doing business in New York failed to pay a judgment, a New York court appointed a receiver over its New York assets in order to protect the New York judgment creditor much as it would in a case involving a human debtor, rejecting the notion that this involved an improper “visitorial power” or interference with the internal affairs of the New Jersey corporation (although the receiver clearly was not merely interfering with but taking over those internal affairs).\footnote{De Bemer v. Drew, 57 Barb. 438 (N.Y. Sup. 1870). I am not clear to what extent the visitorial power was actually exercised. Angell & Ames’ chapter on the subject does not mention any visitation process involving business corporations, although they seem to assume that visitation would be possible. \textit{Angell & Ames}, 537-555.} Courts taking this alternative view rejected Prouty’s broad reading of the jurisdictional statutes and created a doctrine quite similar to modern internal affairs doctrine - except couched in jurisdictional terms. Thus, a Maryland court read Maryland’s equivalent statute - like the New York statute, broadly granting courts
jurisdiction to hear actions against foreign corporations doing business in the state - as no more than a solution to the common law problem that a foreign corporation, because it had no legal existence in the state, could neither sue nor be sued. In this court’s view, actions regarding the internal affairs of foreign corporations still could not be heard:

‘This is clearly a controversy relating to the internal management of the corporation, and the validity of the acts of those who claim to be, and indeed are admitted to be, de facto, its officers and stockholders. Now, if this were a Maryland corporation, there could be no question as to the jurisdiction of a Maryland court over the subject, but such is not the case. The corporation was created by the laws of another state, and it seems to us that all such controversies must be determined by the courts of the state by which the corporation was created.’ ...

It may not be, in all cases, easy to draw a clear line of distinction between the acts of a corporation relating to its internal management, and those which do not. But we apprehend the distinction to be this: That, where the act complained of affects the complainant solely in his capacity as a member of the corporation, whether it be as stockholder, director, president, or other officer, and is the act of the corporation, whether acting in stockholders' meeting, or through its agents, the board of directors, then such action is the management of the internal affairs of the corporation, and, in case of a foreign corporation, our courts will not take jurisdiction. Where, however, the act of the foreign corporation complained of affects the complainant's individual rights only, then our courts will take jurisdiction, whenever the cause of action arises here.45

The court justifies its decision by a fear of conflicting decisions and the possible inability of Maryland to enforce its decision – respect for the sovereignty of the incorporating state is not mentioned. 46

Other courts accepted as a general principle that “courts will not exercise visitorial powers over foreign corporations, or interfere with the management of their internal affairs” while finding particular exceptions beyond those stated in Howells - for example, allowing actions for clear rights, such an order directing issuance of a duplicate stock certificate.47

44North State Copper & Gold Min. Co. v. Field, 64 Md. 151, 20 A. 1039 (1885).
45Other similar decisions, declining to adjudicate disputes regarding “internal affairs” because of an alleged lack of power to enforce the decree, include: Gregory v. New York, L.E. & W.R. Co., 40 N.J. Eq. 38 (1885) ("It is quite manifest that this is not the proper forum for the trial of the question whether that stock was properly issued or not. If the decree should be against the validity of the stock, how is this court to enforce it as against the Buffalo, Bradford and Pittsburgh Railroad Company? It is almost too obvious for remark that this court cannot regulate the internal affairs of foreign corporations, nor can it enforce its decrees out of this state."); Howard v. Mutual Reserve Fund Life Ass'n, 125 N.C. 49, 34 S.E. 199 (1899) (Declining jurisdiction over internal affairs matter because "[o]nly the courts of the state in which the corporation has its residence can enforce their judgment and orders against them; only those courts have power to remove the officers of such corporation for dereliction of duty or to declare a forfeiture of their charters" and citing Field).
46Guilford v. Western Union Telegraph Co., 61 N.W. 324, 325(Minn. 1894) (applying a Minnesota law regarding issuance of duplicate stock certificates in an action involving a New York corporation). ‘The only difficulty is in drawing the line of demarcation between matters which do and those which do not pertain to the management of the internal affairs of a corporation. To entertain an action to dissolve a corporation, to determine the validity of its organization; to determine which of two rival organizations is the legal one, or who of rival claimants are its legal officers; to restrain it from declaring a dividend, or to compel it to make one; to restrain it from issuing its bonds, or from making an additional issue of stock,--would clearly all be the exercise of visitorial powers over the corporation, or an interference with the management of its internal affairs. ... But in the present case there is no question as to the issue, validity, or forfeiture of the stock. ... The only dispute is
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Indeed, that court went so far as to contend that even the consent of the defendant corporation - extracted perhaps as a condition of doing business in the state - would not suffice to give the court jurisdiction over a foreign corporation. Only because the corporation was also chartered domestically could it be sued. Similarly, in the absence of specific statutory authority, a court had no jurisdiction to issue an order mandamus over the terms or conditions upon which that certificate shall be issued. We do not see how the granting of such relief is, in any proper sense, the exercise of visitorial powers, or an interference with the management of the internal affairs of the defendant.”

The Guilford court specifically mentions and rejects the repeated fear of the possibility of conflicting judgments, presenting that as a necessary price for doing justice. It also rejects the notion that New York law, other than the charter of the corporation itself, might prevail over the Minnesota law governing replacement of lost certificates and explicitly refuses to follow the New York procedure. This is the earliest explicit conflict of law discussion I’ve found so far (#23 on the search, 1-20 not yet read).

Thompson v. Waters, 25 Mich. 214, *3 (Mich. 1872). See also, Ohio & M.R. Co. v. Wheeler, 66 U.S. 286 (1861) (Discussing the legal status of a railroad that had corporate charters from two state, C.J. Taney contended, “Yet it has no legal existence in either State except by the law of the State. And neither State could confer on it a corporate existence in the other, nor add to or diminish the powers to be there exercised. It may indeed be composed of and represent under the corporate name the same natural persons; but the legal person or entity, or persons which exist by force of law, can have no existence beyond the limits of the State or sovereignty, which brings it into life and endows it with its faculties and powers.”).

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against a foreign corporation because “[t]he foreign corporation as a legal entity is not here, although its officers, property, and books may be found here.”

Other courts were less extreme. Still, if a foreign corporation was permitted to operate in the state, it could only be at the sufferance of the host state, on the basis of comity. Accordingly, while a corporation could contract out-of-state and such contracts likely would be recognized by comity, its meetings, headquarters and primary existence all had to be domestic, since they were aspects of sovereignty. Prof. Dodd contends that this is a logical outgrowth of Marshall’s Dartmouth College theory that a corporation is an artificial being which exists only in contemplation of the law. If the corporation exists only as a result of law, it follows necessarily that the corporation doesn’t exist outside its home state: “Rhode Island law cannot operate as law in NY.” But Dodd doesn’t explain why it is “necessary” that New York refuse to grant comity or full faith and credit to Rhode Island law regarding the existence of the corporation, and why this is so critically different from the early-on accepted doctrine that a Rhode Island corporation could make contracts in New York.

In any event, the doctrine appears to have been largely abandoned not long after interstate corporations became serious players. In New York,

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50In re Rappleye, 59 N.Y.S. 338 (1st Dept. 1899) (disclaiming jurisdiction to issue mandamus despite New York’s statutory abrogation of the common-law rule that a foreign corporation could not sue or be sued, on authority of Howells and Field).

51Thompson v. Waters, 25 Mich. 214, *4 (Mich. 1872). Comity reaches quite far: “the rule seems to be generally and well settled that the corporate existence, rights of making and enforcing contracts, of acquiring property and transacting business (not requiring the exercise of official corporate action or franchises within the State), of a corporation created by the laws of one State, will be recognized and protected in another; subject only to the qualification, that the enjoyment and exercise of such rights shall not be contrary to the laws or settled policy of the State in which they are sought to be enjoyed or exercised, or prejudicial to the interests of such State or its citizens.” Id. In Thompson, the issue was whether an Indiana corporation could hold title to land in Michigan in the absence of permission from the Michigan legislature.


53DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, 47.

54See supra n. 51; DODD, supra n. 53, at 48, 53-4; Daniel Webster’s argument to the Supreme Court in Deveaux at 561 (stating that as a practical matter, corporations often acted out of state, cotton companies for example purchased cotton out of state, manufactured in their home state and then sold abroad). The lower court in Augusta v. Earle, however, did accept the possibility that an out-of-state contract might simply be void. Compare As Dot-Coms Go Bust In U.S., Bermuda Hosts An Odd Little Boomlet, 1/8/01 WALL ST. J. A1 2001 (WL-WSJ 2850288) (describing tax avoidance scheme where internet companies legally and at least in part physically locate in a tax-free jurisdiction and then sell into the United States without paying American taxes); Costa Rica, Seeking High-Tech Business, Becomes Home to Web Gambling Firms, 10/23/00 WALL ST. J. C26 (2000 WL-WSJ 26614108) (similar).
Merrick v. Van Santvoord [1866] is the leading case in this State, where it was held that a foreign corporation, though it in contemplation of law had its existence as an artificial person solely in the State creating it, nevertheless could lawfully establish even its entire traffic in this State; and its contracts here made by its agents and officers in the ordinary course of business are corporate contracts and do not necessarily involve individual liability. Merrick v. Van Santvoord, 34 N. Y. 208; rev’d, in part, Merrick v. Brainerd, 38 Barb. 574. (Compare Code Civ. Pro. § 1779.) And New Yorkers may go to another State for the purpose of organizing as a corporation there and returning to carry on as its officers and agents here the traffic of the corporation within this State. Demarest v. Flack, 128 N. Y. 205; aff’d 32 State Rep. 675; s. c., 11 N. Y. Supp. 83. Conversely, a New York corporation may be formed and exist in New York for the sole purpose of carrying on a traffic in another State or country (Whitford v. Panama Railroad Co., 23 N. Y. 465).

The issue is not so much whether the corporation “exists” out of state as the degree to which one state will or must recognize attempts by other states to create legal regimes with extra-jurisdictional effects. The earliest view, as we’ve seen, was that a corporation simply did not exist outside of its creating jurisdiction. This quickly evolved to a more limited view that while it could enter into contracts in foreign jurisdictions, it could not be sued or sue. By the turn of the century, Thompson on Corporations (2d ed 1910) acknowledges the older rule – a corporation “is a mere creature of law and has no existence and can do no act beyond the limits of the state or county by which it was created” – but then provides an exception that swallows the rule – “except through the limits of comity [; comity is a part of the common law and] is enforced by the courts in every nation and every state of the union until destroyed by the law making power.”

Thus, the background rule was that foreign corporations can operate freely (and are subject to domestic courts), but that rule is clearly understood to be subject to legislative change.

[Modern doctrine has largely ceased to view foreign incorporation as a significant impediment to domestic operations. Indeed, in recent years, a number of prominent “American” companies, with their headquarters, principal economic operations and main financing sources in the United States, have reincorporated in the Bahamas in order to avoid American taxation. Although there has been some criticism of these moves as unpatriotic, it seems to be generally acknowledged that under current law, the new Bahamian corporation can operate freely in the United States despite its refusal to contribute to the costs of our common enterprise. Quite a contrast to earlier days, in
which a corporation was understood to be an instrument of its chartering state, and thus acting in the interests of another state might well approach disloyalty or even treason.\[^{58}\]

This statement of the rule, however, already hints at its weakness, as the Miller court shows. In that case, the suit was against the directors of a foreign corporation; they were in New York and not necessarily subject to personal jurisdiction in the state of incorporation. Had New York declined to exercise jurisdiction, the directors might not have been subject to suit anywhere, leaving the wrong unremediable anywhere. For this reason, courts limited the reach of the jurisdictional limitation almost from the beginning; indeed, in New York, the doctrine was statutorily overturned as early as 1849.\[^{59}\]

B.

The ancestry of the internal affairs doctrine from a principle of comity led to some reasonable consequences. First, of course, comity, like other common law principles, is subject to legislative change: a state would be free to simply deny entrance to a foreign corporation or to subject entrance to various conditions. (Within the United States, the privileges and immunities clause generally constitutionalizes comity doctrine, removing it from legislative discretion; however, the Supreme Court held in Paul v. Virginia that corporations are not “citizens” for purposes of the privileges and immunities clause.) Courts generally will not extend recognition by comity where the foreign law conflicts

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\[^{58}\]JAMES ELY, RAILROADS & AMERICAN LAW 15-16 (2002) (discussing Pennsylvania Attorney General’s view in 1865 that railroad’s acceptance of a charter from another state was akin to “treason”).

\[^{59}\]N.Y.B.C.L. 1314, derived from a 1920 amendment to the Gen. Corp. Law, in turn derived from Code Civ. Proc. 1780, enacted in 1849 and amended in 1880. The original text appears in New York Law 1849, ch. 107 “An Act to extend the remedies at law against foreign insurance companies”. Despite the title, the Act is not limited to insurance companies. Rather, it permits suits “against any corporations created by or under the laws of any other state, government or country, for the recovery of any debt or damages, whether liquidated or not, arising upon any contract made, executed or delivered, within this state, or upon any cause of action arising therein...” Thus, even before the widespread rise of out of state corporations, New York had abolished the original form of the Internal Affairs Doctrine.
with important local law principles. Thus, one would expect a comity-based doctrine to have various exceptions.

These exceptions paralleled, but do not precisely match, the received doctrine about internal affairs. In particular, under comity (as under modern internal affairs doctrine), the line between those matters that are subject to local law and those that follow the corporation is not always obvious. Thompson on Corporations, in 1910, lists several instances where local law would apply to foreign corporations, in some ways reflecting a distinction akin to the internal/external affairs line. Thus, he suggests that to determine whether a corporation has acted ultra vires, one should always look to its charter - the law of the incorporating state.

Conversely, he states that local law applies to some matters that seem clearly to be matters of external regulation, following easily from the general principle that comity never allows a foreign corporation to exercise powers barred to local corporations: local usury rates apply to foreign corporations; local restraint of trade and anti-trust laws apply. But Thompson also lists – without distinguishing them analytically – types of local regulation that might at first glance appear internal: local laws override the law of the state of incorporation regarding preferences in insolvency and the life of the corporation (what could be more internal than that?). Similarly, New York applied its statutes requiring directors of corporations to file annual reports -and imposing on them personal liability for the corporation’s debts if they did not - to foreign as well as domestic corporations; the court treats the problem as no more than construal of somewhat ambiguous statutory language. In that instance, then, the New York high court seems to have not even considered the possibility that limited liability might be a matter that ought to be regulated by the incorporating state. Interestingly, Thompson is still close enough to the older jurisdictional view that he adds to this discussion another New York case which appears only to hold that New York courts have jurisdiction to hear a derivative case involving a foreign corporation - even though the decision he cites does not discuss the question of what law will be used to determine the duty of the directors.

In some instances, the fiction of foreignness was relied upon even where it clearly gives the foreign corporation advantages denied to a domestic one: for example,

60Thompson at sec. 6628.
61Thompson at sec. 6628.
62Staten Island Midland R. Co. v. Hinchliffe, 170 N.Y. 473, 480 (1902)(interpreting statute to apply to foreign corporations with no discussion of internal affairs or other possible limitations on applicability to foreign firms) (cited in Thompson sec. 6630). The statute specifically included foreign corporations in the requirement to file reports, but did not do so in the section imposing personal liability on directors; a court bothered by this as interference in the internal affairs of a foreign corporation easily could have read the statute not to reach directors of foreign firms.
63Miller v. Quincy, 179 N.Y. 294 (1904) (director of foreign corporation with headquarters in New York sought to bring derivative action against fellow directors for waste), cited in Thompson at sec. 6630.
Thompson states that a foreign corporation is entitled to be treated as out-of-state for purposes of the statute of limitations—even if, in substance, it was not out-of-state at all.64 (The same rule applied for federal diversity jurisdiction from 1844,65 until 1958, when 28 U.S.C. 1332 was amended to make corporations additionally citizens of their principal place of business for diversity purposes.66)

64Thompson at sec. 6630.
65In Bank of United States v. Deveaux, 9 U.S. 61, 85, 86 (1809) (holding that for diversity purposes a corporation is a citizen of the state of which its human members are citizens) the Supreme Court held that corporations are not citizens, but that diversity jurisdiction should be determined as if the corporation had no independent existence but were a “company of individuals” or a “name” for its members suing collectively. (This view continues to influence corporate speech doctrine, which resolutely pretends that corporations are nothing more than voluntary associations of citizens similar to a Committee of Correspondence. See, Greenwood (Iowa).) Had the Deveaux doctrine remained good law, all modern public corporations would be denied diversity access: publicly traded firms typically have shareholders in every state of the union and thus would never be diverse.

In 1844, however, the Court reversed position and instead adopted the view that for diversity purposes, a corporation should be treated as if it were both an inhabitant and a citizen of the state in which it is incorporated. Louisville RR v. Letson, 43 U.S. (2 How.) 497, 555, 557 (1844) (“a corporation created by a state ... seems to us to be a person, though an artificial one, inhabiting and belonging to that state, and therefore entitled, for the purpose of suing and being sued, to be deemed a citizen of that state”). Of course, corporations are not citizens for other purposes, such as voting or apportionment, so the textual basis of this doctrine is weak, at best. See, e.g., Marshall v. B.& O. Rwy, 57 U.S. (16 Howe) 314, 338 (1853) (dissenting opinion of Daniel, J.).

In the years following Letson, the Court continued to waver in its theory of jurisdiction while consistently providing a federal forum for suits involving corporations. Thus, in Marshall v. B&O Rwy, 57 U.S. (16 Howe) 314, 325-29 (1853) (reaffirming that actual citizenship of actual shareholders is irrelevant to citizenship of corporation), it based jurisdiction on the presumed “residence” of the “members” of the corporation, arguing that since a corporation rarely could be sued anywhere but in its state of incorporation, its members were estopped from claiming residence elsewhere. This presumption, like the Letson claim that a corporation must be located where it is incorporated, may have had some connection to reality in 1853, see Dodd at 153, but lasted as a legal matter long after it became quite pure fiction. (Dodd contends that in 1853, there were several prominent corporations with ownership and directors in one state and factory in a different one, but few examples of the modern phenomenon of incorporation in a state with which the firm has no business connection at all).

I have not found any American case which has taken the Letson rule to require any inquiry into the actual “residence” of the corporation: it has been understood to refer to its state of incorporation, not the location of its operations. (In contrast, the civil law developed elaborate doctrines to determine the location of a corporation, recognizing that a firm may be located in one place and incorporated in another). But see, Northern Indiana RR v. Michigan Central RR, 15 Howe 233, 249 (1853) (Catron, J., dissenting) (arguing for a rule like the civilian Siege Real rule, on the ground that it would be unfair to allow a corporation owned and operated in one state to sue its neighbors in Federal court merely because it was incorporated elsewhere – an argument ultimately accepted by the Congress in 1958).

Similarly, it appears that each time the reigning theory of jurisdiction would have excluded federal jurisdiction, the Court changed theories. Thus, the Deveaux theory of looking through the corporation was not enough to bar a suit against a corporation entirely owned by a state, Bank of Kentucky v. Wister. Once shareholders began to be more diverse, so that the Deveaux theory would have regularly precluded jurisdiction, the Court began to presume that shareholders were located in the state of incorporation. Letson, Marshall. But when that presumption would have defeated jurisdiction— in a suit against an Ohio corporation by its Connecticut shareholder, the Court didn’t apply it. Doctor v. Harrington, 196 U.S. 579 (1905).

“PL 85-554. According to the legislative history, the purpose of the change was to lessen the burden on federal courts by reducing “fictional ... diversity”: “the fiction of stamping a corporation a citizen of the state of its incorporation has given rise to the evil whereby a local institution, engaged in a local business and in many cases locally owned, is enabled to bring its litigation into the Federal courts simply because it has obtained a corporate charter from another State.” Sen. Rep. 85-1830, at *3101-2. This fictional diversity was seen as “unfair” to local competitors without foreign incorporation (presumably because the federal courts were viewed as a superior forum) and as irrelevant to the “underlying purpose” of diversity
Intriguingly, comity didn’t necessarily extend to recognizing “tramp” corporations: corporations formed by the citizens of state A to do business in state A, but incorporated under the laws of state B. Thompson reports that several states viewed this as per se fraud and others viewed the resulting corporation as invalid if the foreign incorporation was done with intent of “evading [the domestic state’s] laws”. Curiously, however, a number of state supreme courts promptly held that the requisite intent couldn’t be proven simply by evidence that a firm was a classic tramp. For example, in one case, the subscribers to 49 of 50 shares of a New Jersey corporation were Missourians, it had no plans to do business in New Jersey, all its assets were in Missouri and the bulk of its business would be construction in Kansas City. Rather than compelling Missourians to follow Missouri law, as the legislature appears to have intended, the Missouri Supreme court converts the issue into one of comity, and holds that the New Jersey corporation is entitled to a license to do business in Missouri unless its charter violates a Missouri policy in a way that would bar it under ordinary comity doctrine. The court then concludes that there is no advantage to incorporating under New Jersey law – ignoring the obvious question why, in that case, the shareholders went to the trouble of doing so – and thus no evasion of Missouri law. Thus, the key element in the modern doctrine was set.

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Comity doctrine was recognized by the U.S. Supreme Court, as one would imagine, as leaving the recognizing state entirely unfettered: the power of the state over foreign corporations remained, even if unexercised, “as extensive as its power over domestic corporations.”

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jurisdiction – avoiding local prejudice. The Senate Report acknowledges in passing that the reform would not eliminate the problem with respect to national corporations doing business in multiple jurisdictions, as it maintains the fiction that every corporation has only a single “principal place of business.”

67State ex rel. Brown Contracting & Building Co. v. Cook, 80 S.W. 929 (Mo. 1904) (upholding validity of foreign tramp corporation in face of statute apparently outlawing the practice), citing and relying upon Demarest v. Grant, 28 N.E. 645, 649 (N.Y. 1891) (finding no New York policy discouraging New Yorkers from forming corporations out of state). Ex rel Brown’s reliance on Demarest is somewhat odd, given that Missouri had a statute expressing precisely the policy that Demarest did not find in New York.

68Thompson at sec 6641, citing Orient Ins. Co. v. Daggs, 172 U.S. 557 (1899) (upholding a Missouri statute governing interpretation of insurance contracts as applied to Connecticut corporation against claim that such limitations must be in corporate charter or are beyond power of state). A fuller discussion of a state’s right to exclude or regulate foreign corporations appears in Hooper v. People of State of Cal., 15 S.Ct. 207 (1895) (holding that insurance policies are not articles of commerce within the meaning of the interstate commerce clause).
In the modern era, the internal affairs doctrine seems more appropriately understood as a choice of law doctrine, perhaps limited by underlying federalism principles, rather than centrally an issue of comity between sovereigns. Perhaps the difference is not overwhelmingly important. The emphasis, however, is.

Comity treats the corporation as a sovereign act of a foreign (or sister) state: the beginning of discussion is how New York, for example, shall treat a legislative act of Delaware. Analyzing the issue this way naturally leads to questions of whether, in fact, Delaware’s sovereignty would be threatened or reduced by New York failing to do so. In the era of general incorporation laws, it is hard to see what interest of Delaware as a sovereign state would be infringed were other states to restrict the ability of their citizens to avail themselves of a service Delaware offers to people who are not its citizens.

Moreover, comity analysis suggests a countervailing issue to concerns about Delaware’s respect as a member of the community of nations (or of American states): Is it not the case that Delaware is overstepping the boundaries of a geographically based sovereignty when it legislates about matters that occur largely outside Delaware? Delaware law, applied to a corporation that will function largely outside its borders with economic impacts overwhelmingly outside its borders, determines the mutual responsibilities of human participants in that corporation (for example, by setting the standards for limited liability, declaration of dividends, standards of care and loyalty, rules for mergers and other extraordinary combinations, and rules for internal corporate governance) even though those humans and their relationships may be entirely extraterritorial. Comity analysis in the twentieth century, when corporations routinely incorporate in states, especially Delaware, different from the center of their activities, easily and quickly leads to the conclusion that other states owe no particular respect to Delaware’s corporation law. As a matter of comity, Delaware appears to be poaching on other states, legislating as to matters that are primarily outside its territory.

The modern shift to conflict of laws analysis may give rise to a somewhat different perspective. Conflict of laws treats the issue not as one of sovereign to sovereign relations but as a matter of private law: a dispute has arisen and the forum state must decide what law it should apply to the dispute. Standard conflict of laws doctrine recognizes that in many instances more than one jurisdiction appropriately may apply its laws to a particular dispute or transaction, so that different forum states may reach different conclusions about which law to apply. Moreover, the analysis typically does not invoke the specter of states invading each others sovereignty that figures so large in
the comity analysis. In this reduced stake game, the issue is merely which state has the most significant relationship to the parties and each particular issue involved. 69

Conflicts analysis begins with the legal issue at stake. Were corporate “internal affairs” considered under the usual doctrine, the first issue would be characterizing particular disputes as tort, contract or status. Some corporate law disputes seem obviously to be in the tort category: the common derivative actions for breach of duty of care or duty of loyalty, for example, are clearly negligence type actions (even though the business judgment rule imposes a lower standard of care than in the ordinary negligence action).

In a tort action, courts will look first to the interests of the states involved. They ask such questions as, where the allegedly tortious conduct occurred: in most cases that is the state that will have the strongest interest in deterring such conduct. Or, where the victim is domiciled or was injured: that state, or states, will have the strongest interest in compensating the injured party. 70 Since these torts involve a relationship between the parties, at least formally, the location of that relationship may be critical, and under ordinary tort conflict of law principles, that would be the place where the relationship is centered. 71

None of these principles lead automatically to an obvious result in all corporate law disputes. But they point in a consistent direction away from Delaware: disputes about how the company is run ought to be located either in the state where the company is run, or in the state where the people who run the company are located, or in the state where the disputants entered into their relationship. In the ordinary course, the choice under these principles would be between the state where the corporation is headquartered (presumably the location of any breach by its managers or directors) or possibly the state where relationships were entered into - for disputes involving shareholders of publicly held corporations, presumably either New York, where the stock exchange is located, or the shareholders’ home state, where they initiated the relationship, or, again, the headquarters of the corporation, where the relationship was consummated and centered. In any event, the state of incorporation is nearly irrelevant to any of these issues.

*Limited Liability, Minimum Capital Rules, and the Like

Limited liability and related doctrines, such as the permissibility of issuing dividends, paying large salaries to key insiders and other ways of extracting funds from

69Restatement of the Law, 2d, Conflicts, § 145 (stating general rule of conflicts with respect to torts). The most common “internal affairs” litigations probably are those involving alleged breach of duty of care or duty of loyalty, which clearly are tort actions. The “internal affairs” matter of limited liability also affects, at least implicitly, every tort action involving a corporation or an actor that potentially could become a corporation or equivalent. (Although this Article focuses on corporations, the structure of limited liability company is almost identical. Compare U.L.L.C.A. with R.M.B.C.A.).

70Restatement of the Law, 2d, Conflicts, § 145, comment (e).

71Restatement of the Law, 2d, Conflicts, § 146.
the corporation to benefit insiders rather than creditors, are considered “internal affairs” under current doctrine. These doctrines govern who has access to corporate funds and in what order. Thus, if a corporation is permitted to issue a dividend, those funds are likely to be unavailable to later creditors (first as a legal matter, unless fraudulent conveyance law, with its typically short statute of limitations, applies, and second, at least in the case of publicly traded firms, as a practical matter).

Similarly, if a firm pays its top executives large sums of money, those funds are no longer available to outside creditors. When corporations issue stock or stock equivalents to top managers, at first glance outside creditors may seem to be unaffected; the main result of such payments is to transfer claims against the corporation from one group of shareholders (the non-managers) to another. However, in practice such grants are often accompanied by stock buy-backs: in order to avoid excessive dilution of previously issued stock, companies buy their own stock in quantities related to the new stock or stock options issued, so that the number of outstanding shares is not greatly increased. Any purchase of its own stock by a corporation is a transfer of funds out of the corporation to shareholders that is, from the perspective of outside creditors, no different from a dividend. Even more obviously, when companies agree to buy their own stock directly from managers, or when, instead of issuing actual stock to managers they create shadow stock or obligations to pay cash amounts based directly or indirectly on changes in stock price, the effect is a cash transfer to insiders that reduces the corporate funds available for other creditors. Thus, large payments to executives, like dividends, directly impact all creditors of the firm.

Under current accounting procedures, corporations account for (and managers are encouraged to think of) most payments from the corporate bank account as expenses to the corporation. Most simply, payments to employees make the corporation poorer - employees are not the corporation. Neither are customers, neighbors or society as a whole. If, for example, the corporation decides to manufacture a product in a safer or less polluting, but more expensive way, standard corporate accounting requires reporting that the corporation is poorer for this decision without regard for the benefits of safety or non-pollution: those accrue to outsiders, not to the corporation. Similarly, if it chooses a manufacturing process that increases employee interest or satisfaction, the benefits are deemed to belong to the employees and are not reflected on the corporation’s books unless it is able to reduce monetary payments to employees or the equivalent.

There are two large exceptions to this rule, however. Payments to shareholders do not reduce corporate profits: they are made out of profits. Conventional accounting, that is, to this extent views the corporation as its shareholders, rather than as its product, employees or contribution to society. Second, stock options issued to employees - in practice, to top executives - also are not accounted as expenses to the corporation, even though they clearly reduce the assets available for stockholders, and, at least when they are accompanied by corporate stock purchase programs, for other claimants. Here,
inconsistently, current accounting appears to view the option-receiving employees as a
special kind of partner - like partners, payments to them are not viewed as expenses
(partners are the enterprise); unlike partners, however, they appear to owe no
responsibility to account to fellow partners (or shareholders) a clear accounting of what
they are taking out of the business. (Alternatively, option accounting reflects a view that
options don’t cost anything - they are a distinctly implausible, if attractive, perpetual
motion machine).

Internal accounting, the duties of top managers to shareholders and other corporate
constituents, the rules regarding transfer of corporate assets to others, are each classic
matters of internal affairs. But on ordinary conflict of laws interest analysis, they ought
not to be governed by the law of the incorporating state: these are rules that determine
how the corporation functions as a part of the greater economy in which it is enmeshed.
And that is not Delaware’s economy nearly so much as the economies of the states in
which the firm does business.

These are the rules that determine whether a corporation will have assets available to
meet its obligations under tort and tort-like regimes. When Delaware determines these
rules for corporations doing business elsewhere, it is necessarily determining the degree
to which the tort and related regulations of the host states will be effective. A regulator
can regulate (whether directly or through tort law) only if there is a there there to
regulate. Delaware’s rules regulating the corporation’s internal affairs determine
whether there is a there there.

*Fiduciary Duties.

Corporate law fiduciary duties raise a similar set of issues. Fiduciary duties - of care
and loyalty, from directors and managers to both the corporation and its shareholders -
are typically considered matters of internal affairs, governed by the law of the state of
incorporation. Here too, the state or states that are affected are likely to be the host states
- the states in which the corporation is active - rather than the incorporating state.
Accordingly, in a standard conflicts regime, host states would be free to impose their own
law and forum states would be required to choose among the laws of host states, with the
place of incorporation entitled to little if any weight.

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From a different perspective, Delaware regulation of national firms may seem more
reasonable. Conflict of laws regarding contracts is more flexible than the conflict of laws
rules regarding torts. In particular, it is commonplace for contractual parties to choose
the law that will interpret and regulate their contracts, just as they choose the terms of the
contract itself.
Before exploring this alternative metaphor for corporate choice of law in detail, it may be helpful to notice how limited it is. First, many corporate obligations are not contractual at all. Neither tort nor general regulatory provisions are usefully seen as contractual. Tort victims do not negotiate with their tort feasors over the law that will be applicable. Nor do states typically permit economic actors to choose whether they would prefer to be regulated under the states regime or an alternative one. Yet Delaware’s limited liability rules seemingly mark the limit of the host state’s regulation: if Delaware determines that the corporation’s assets can be freely used for alternative projects, or if Delaware creates fiduciary obligations that direct management’s gaze elsewhere, the host state’s regulatory regime will be correspondingly reduced.

Indeed, more generally, all doctrines of internal corporate governance that determine when the corporation may enter into contracts or assume other obligation and when it may make payments that remove assets from the corporation necessarily affect all creditors of the corporation. Virtually any significant action a corporation takes, whether entering into a new investment, embarking on a potentially tortious activity, or choosing to finance itself in one manner rather than another, affects the ability of creditors to collect from it.

For this reason, corporate governance generally, and limited liability and executive salaries particularly, are fundamentally related to the effectiveness of tort and contract law generally. Limited liability determines the extent to which there is a there there for tort (or any other body of state law) to regulate. Corporate governance more generally determines the extent to which corporate decision-makers will internalize state law norms or view them as obstacles to be evaded to the greatest degree possible.

Ordinary conflict of laws doctrine, accordingly, might often refer to tort norms in determining what law to apply to a corporation. If a corporation establishes internal governance mechanisms that induce corporate decision-makers to view, for example, safety mechanisms or pollution reduction as a cost, while viewing payments to shareholders or top executives as