Opportunism and Internal Affairs

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The internal affairs doctrine is the sine qua non of modern corporate law. It assigns to a corporation's chartering state sole authority to govern relations among constituents "inside" the firm—its stockholders, directors, and officers—while leaving to territorial law the relations between "outside" constituents and the firm. But why law should cleave an enterprise in this way is a puzzle. Economic theories of the firm cannot explain it, and the academic literature is short on answers.

This Article offers an account of the internal affairs doctrine that simultaneously explains the doctrine's contours, accords with its historical emergence, and defends its status as one of the economy's central organizing principles. It argues that the internal affairs rule is best understood as the law's adaptive response to a collective-action problem distinctive—historically—to stockholders. Because selling shares across state borders is cheap, shares would, absent the rule, tend to flow into jurisdictions that provide stockholders with robust capital withdrawal and control rights, even where such rights, in the aggregate, would undermine the corporate form's signal virtues. The internal affairs doctrine forestalls opportunistic trading and so facilitates capital formation. Moreover, as this Article shows, the doctrine in fact emerged in the years following economic and legal changes that made such trading a threat for the first time. The prospect of opportunism, then, rather than anything inherent in the idea of the firm, defines the corporate boundary.

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I. INTRODUCTION

The internal affairs doctrine is the foundation on which modern corporate law is built. It holds that the chartering state[1] alone should govern a corporation's "internal affairs"—what the Restatement (Second) of Conflict of Laws defines as "the relations inter se of the corporation, its shareholders, directors, officers or agents."[2] In contrast, the rights and obligations of "third persons," namely those other than "the directors, officers or stockholders of the corporation," are subject to ordinary conflicts analysis.[3] Relationships inside the corporation are governed by one body of law; relationships outside it, by another. This bifurcation is axiomatic among practitioners and scholars alike,[4] as it has been since shortly after judges first formulated the rule in the

1. For economy, this Article will use "chartering state" to refer to a firm's state of incorporation, even where incorporation is achieved by filing articles. "Host state" will refer to a jurisdiction, other than the chartering state, in which a corporation does business.

2. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 cmt. a (AM. LAW INST. 1971). There is no single, orthodox formulation of the doctrine, but the Second Restatement is exemplary.

3. *Id.* § 301 cmt. a.

4. *See, e.g.*, Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, LAW & CONTEMP. PROBS., Summer 1985, at 161, 161 ("To many corporate lawyers, the 'internal affairs' doctrine . . . is irresistible if not logically inevitable."); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 19 ("[T]he lex incorporationis principle is generally treated as axiomatic."); Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 33 (2006) ("To the modern corporate scholar and lawyer, the internal affairs doctrine seems in the natural order of things.").

1860s.[5] In fact, it defines corporate law as a distinctive field of practice and inquiry, since, in the words of one former Delaware chancellor, corporate law just is "that body of statutes and case precedent that governs the *internal* organization and functioning of the [corporation]."[6]

Yet the doctrine is puzzling. The cleavage it draws between a company's equity capital providers and management, on one hand, and all other constituents who make durable investments in the enterprise, on the other, seems to contravene the economic theories of the firm that have dominated corporate law scholarship for a generation. Contractarian theories deny outright the conceptual coherence of a boundary between insiders and outsiders. Indeed, the metaphor of the "nexus of contracts" is calibrated precisely to emphasize the common ground on which an enterprise's various constituents stand.[7] The same goes for proprietary theories of the firm, which modify and have largely supplanted purely contractarian thinking.[8] Proprietary, unlike

5. The phrase first appeared in a judicial opinion in *Howell v. Chicago & North Western Railway Co.*, although its gist dates to a little earlier. 51 Barb. 378, 383 (N.Y. Sup. Ct. 1868). For the story of the rule's emergence, see discussion *infra* Part IV.

6. William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 262 (1992) (emphasis added). The internal affairs rule is for this reason central to the most important developments in, and debates about, corporate law. For example, exponents of both sides of the shopworn "race" debate ground their stories in a chartering-state's authority to dictate the terms on which stockholders and managers do business. *Compare, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974), *with* Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). It could not be otherwise, because the possibility of jurisdictional competition rests on the lack of necessary connection between a firm's physical presence and its chartering state. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1-13 (1993).

7. The phrase dates to Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976). Its gist is in Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 794 (1972) ("No authoritarian control is involved [in the firm]; the arrangement is simply a contractual structure subject to continuous renegotiation with the central agent."). A radical way to put the idea is to deny the very existence of things identifiable as firms. *See* G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 887 (2000) ("[T]here are no firms . . . ."); *see also* Anthony J. Casey & M. Todd Henderson, *The Boundaries of "Team" Production of Corporate Governance*, 38 SEATTLE U. L. REV. 365 (2015) (advancing related view with respect to governance attributes). For an application of this insight to the law of corporate rights, see Vincent S.J. Buccola, *Corporate Rights and Organizational Neutrality*, 101 IOWA L. REV. 499 (2016).

8. Proprietary theories hold that a firm's ownership of assets is important because property rights and contractual rights differ in legal significance and that therefore the *contract* metaphor misses important features of legal firms. On the relationship between contractarian and proprietary theories, see John Armour & Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD J. LEGAL STUD. 429 (2007).

contractarian, analysis makes use of the idea of a firm's boundaries—but boundaries defined in terms of assets rather than people or relationships.[9] What, then, explains the internal affairs rule? How, if at all, can it be justified?

The literature is remarkably short on answers.[10] When scholars have sought to account for the internal affairs rule, they have typically done so by pointing to one or another of the values it is said to advance: freedom, predictability, consistency, and uniformity.[11] Invariably,

9. *See, e.g.*, Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 692 (1986) ("We define the firm as being composed of the assets (e.g., machines, inventories) that it owns."). Since Sanford Grossman and Oliver Hart's influential paper, legal scholars who explore law's implications for observed patterns of organization have typically used the boundary notion the same way. *See, e.g.*, Kenneth Ayotte & Henry Hansmann, *Legal Entities as Transferable Bundles of Contracts*, 111 MICH. L. REV. 715 (2013); Oren Bar-Gill & Gideon Parchomovsky, *Law and the Boundaries of Technology-Intensive Firms*, 157 U. PA. L. REV. 1649 (2009); Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, 124 YALE L.J. 2680 (2015); Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 494 (2009); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 399-401 (2000); Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515 (2007); George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102 (2004).

10. Most scholarship on the internal affairs doctrine concerns not its foundations, but its wisdom in modern institutional settings. A raft of articles on that subject appeared in the 1980s in response to the then-recent wave of anti-takeover legislation and the Supreme Court's decisions in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987) and *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). *See* Norwood P. Beveridge Jr., *The Internal Affairs Doctrine: The Proper Law of a Corporation*, 44 BUS. LAW. 693 (1989); Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CALIF. L. REV. 29 (1987); DeMott, *supra* note 4; Kozyris, *supra* note 4; Jed Rubenfeld, *State Takeover Legislation and the Commerce Clause: The "Foreign" Corporations Problem*, 36 CLEV. ST. L. REV. 355 (1988). Similar views were aired a generation earlier. *See* Stanley A. Kaplan, *Foreign Corporations and Local Corporate Policy,* 21 VAND. L. REV. 433 (1968); Elvin R. Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955); Willis L.M. Reese & Edmund M. Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 1118 (1958); *see also* Hon. Jack B. Jacobs, *The Reach of State Corporate Law Beyond State Borders: Reflections upon Federalism*, 84 N.Y.U. L. REV. 1149 (2009) (discussing the practical implications of the divergence from the internal affairs doctrine as a result of state anti-takeover statutes).

11. *See* discussion *infra* Part II.B. An important exception is Tung, *supra* note 4. Frederick Tung's thesis is chiefly negative, however. His aim is to show that the internal affairs doctrine did *not* emerge in order to facilitate charter competition, as some assumed, and indeed that, because the doctrine predated the merger movement of the late-nineteenth century, it *could not have* emerged for that purpose. My findings are consistent with Tung's, but my aim is to provide a positive account that both justifies the doctrine's contours and is consistent with its emergence in the 1860s.

though, such accounts fail to explain the doctrine's *limits*.[12] If these values are so important, why does the rule not cover a company's workers or suppliers or debt financiers—or anyone else who makes durable investments in the enterprise? Presumably all constituents enjoy freedom, predictability, and the rest. So why are stockholders special?

This Article offers the first account of the internal affairs doctrine that simultaneously explains the doctrine's contours, accords with its historical emergence, and defends its status as one of the economy's central organizing principles. On the account offered here, the internal affairs rule is best understood as the law's adaptive response to a collective-action problem unique—historically—to stockholders among corporate constituents. Absent the doctrine, I argue, opportunistic movement by stockholders would threaten to undermine the corporation's signal virtue as a mode of coordination—its capacity to lock in capital.[13]

To see why, suppose for a moment that choice of law in stockholder suits were akin to that in, say, personal injury cases. The place where the plaintiff claims to suffer injury, typically her state of residence, would supply the law.[14] Holding constant the rights of fellow investors, any one stockholder prefers her own capital withdrawal and control rights to be stronger rather than weaker. These

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12. *See* discussion *infra* Part II.B.

13. For the argument that the corporate form's distinctive historical advantage lay in its capacity to lock in capital investments, see Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression*, *in* CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY 125, 135 (Edward L. Glaeser & Claudia Goldin eds., 2006) (arguing that the corporation's advantage over the partnership lay in its resolution of the problem of "untimely dissolution"); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 390 (2003) (arguing that the corporate form facilitated capital formation by separating equity-capital providers from control and withdrawal rights); Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1338 (2006) (arguing that "strong entity shielding" is the distinctive contribution of the corporate form (emphasis omitted)). For a contrary view on the distinctiveness of the corporation, see John Morley, Essay, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 COLUM. L. REV. 2145, 2196-97 (2016) (arguing that the common-law trust could have supported capital-intensive industry under law prevailing in the nineteenth century). For an insightful argument that another seemingly arbitrary convention—the distinction between injury to a corporation and injury to its constituents—is in fact central to maintaining the virtues of the corporate form, see J.B. Heaton, *What Injures a Corporation? Toward Better Understanding Corporate Personality*, 73 BUS. LAW. 1031 (2018).

14. This is only a modest simplification of the dominant conflicts rule for delicts. *See* RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 146 (AM. LAW INST. 1971).

rights are valuable options. In our counterfactual world, then, any one share would be more valuable when held in a jurisdiction providing robust withdrawal and control rights. Because stock is mobile, shares in this world would tend to flow to "interventionist" jurisdictions, even though the net result might be to undermine the virtues of capital lock-in. My claim is that by declaring irrelevant the law of the jurisdiction in which stock is held, the internal affairs doctrine forestalls a destructive if unconventional "race to the bottom."[15]

In principle, there is nothing special about stockholders in this analysis. An analogous collective-action problem could plague any constituents who make durable investments. The problem is a general one of opportunistic movement—physical relocation after investments have been priced and made—to jurisdictions with privately favorable law. But as a contingent matter, stockholders are unique in their ability to move opportunistically, or at least historically they have been unique.[16] To illustrate, return to tort and consider the position of a customer who buys a potentially defective product. It may be that a state other than the state of purchase and residence has more favorable product liability law, from the customer's perspective. That is, there may be some reason to move opportunistically. But to take advantage of legal diversity—which of course will matter only if the product is arguably defective and causes an injury—the purchaser must physically relocate to and become a resident in the more favorable jurisdiction. Doing so is expensive in a way that selling stock plainly is not. Opportunistic movement by customers is practically unimportant, and consequently the law tolerates their inconsistent treatment. In brief, the corporation's boundaries are a function of the cheapness of selling stock across state lines.[17]

This analysis has a number of implications for our thinking about the corporation. Two fundamental insights will be developed here. First, the sense in which stockholders are unique among corporate

15. As this idea is conventionally employed, the race suggests a dynamic in which managers choose law in a manner that harms stockholders—and ultimately firm value. Here it is stockholders themselves who choose law and threaten joint value.

16. *See* discussion *infra* Part III.

17. I do not claim that the judges who first articulated the internal affairs doctrine were in fact subjectively motivated by a desire to see the corporate form thrive. I am aware of no documentary evidence to that effect, and the rule's authors are not talking. The historical evidence marshaled here shows only that the internal affairs doctrine emerged in the years immediately after opportunistic movement by stockholders became a real possibility for the first time and in the context of disputes concerning stockholders' right to withhold or withdraw capital investments. *See* discussion *infra* Part IV.

constituents is, as I have already suggested, historically contingent. Precisely because of its contingency, the corporate boundary lacks essential significance. This means, among other things, that one ought to be skeptical of deferring to Delaware's articulation of the objective function of the corporation or its constituents. The enterprise is the relevant unit of economic interest, and corporate law's domain extends only to a subset of the relationships that constitute it. Second, when the internal affairs doctrine took hold in the second half of the nineteenth century, the problem of opportunistic movement was limited, for technological and institutional reasons, to stockholders in particular. Many of the conditions that then distinguished stockholders from other corporate constituents still hold today, a fact that helps to explain the doctrine's longevity. But if conditions change along relevant margins, as there are reasons to think they are in the process of doing, one might expect, or even hope for, a change in the very definition of the corporate boundary.[18]

The balance of the Article proceeds as follows. Part II briefly describes the internal affairs doctrine and evaluates existing accounts of its origins and functions. Part III introduces the notion of opportunistic movement and argues that the internal affairs doctrine is calibrated to prevent opportunism from undermining capital lock-in in an environment characterized by national economic markets and federated legal jurisdictions. Part IV shows that the doctrine in fact emerged in cases concerning capital formation during the years immediately following changes in the economic and legal landscape that made opportunistic movement by stockholders possible. Part V discusses implications for our understanding of the corporation.

II. BACKGROUND ON INTERNAL AFFAIRS

A. *The Doctrine Today*

As it was initially understood, the internal affairs doctrine acted as a rule of "legislative" jurisdiction—which can make binding rules—but also, and indeed primarily, as a rule of "adjudicatory" jurisdiction—which can resolve disputes.[19] The rule held that (1) chartering-state law would govern disputes about the rights and obligations of stockholders and officers that derived from their participation in the corporation, and (2) when a stockholder pressed a claim, the

18. *See* discussion *infra* Part V.B.
19. *See* discussion *infra* Part II.B.5.

chartering-state's courts would resolve it.[20] During the first half of the twentieth century, however, the courts jettisoned the "adjudicatory" component of the doctrine.[21] They came to see it as but an application of *forum non conveniens*, and it is now defunct.[22]

Today, then, the internal affairs doctrine is a choice-of-law rule, pure and simple. It undergirds the entirety of modern corporate law, and its vitality generally goes unquestioned.[23] The rule has no orthodox articulation, but the United States Supreme Court's most recent statement is representative: "The internal affairs doctrine is a conflict of law principle which recognizes that only [the chartering state] should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders . . . ."[24]

To the extent the internal affairs doctrine is contested, disputes primarily concern the doctrine's legal source—in particular, whether the rule is an artifact of constitutional moment or just an interpretive default to which legislatures have for the most part acceded.[25] Authorities line up on both sides of the issue. The courts of Delaware, the state most advantaged by the rule, are the boldest advocates of a

20. *See* discussion *infra* Part II.B.5.

21. A full account of the rule's evolution is beyond this Article's scope. The story is an intriguing one, though, and a handful of midcentury law review notes tell it well. *See* Note, *Forum Non Conveniens and the "Internal Affairs" of a Foreign Corporation*, 33 COLUM. L. REV. 492 (1933); Note, *Forum Non Conveniens as a Substitute for the Internal Affairs Rule*, 58 COLUM. L. REV. 234 (1958); Note, *The Development of the "Internal Affairs" Rule in the Federal Courts and Its Future Under* Erie v. Tompkins, 46 COLUM. L. REV. 413 (1946) [hereinafter Note, *The Development*]; Note, *The "Internal Affairs" Doctrine in State Courts*, 97 U. PA. L. REV. 666 (1949).

22. Intriguingly, the recent vogue among Delaware corporations for forum-selection bylaws and articles provisions can be seen as a kind of innovative reinvention. *See* Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiforum Shareholder Litigation* (European Corp. Governance Inst., Working Paper No. 295, 2015), https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2624951.pdf (documenting the phenomenon); DEL. CODE tit. 8, § 115 (2018) (affirmatively authorizing such provisions).

23. *See, e.g.*, Kozyris, *supra* note 4, at 19 ("[T]he lex incorporationis principle is generally treated as axiomatic."). If there has been an incursion into the significance of internal affairs, it is due to the growth of federal securities law rather than state abnegation.

24. Edgar v. MITE Corp., 457 U.S. 624, 645 (1982); *see also* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1113 (Del. 2005) ("The internal affairs doctrine applies to those matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders."); McDermott Inc. v. Lewis, 531 A.2d 206, 214 (Del. 1987) ("Internal corporate affairs involve those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders.").

25. For a more thorough discussion of the legal sources at issue, see Vincent S.J. Buccola, *States' Rights Against Corporate Rights*, 2016 COLUM. BUS. L. REV. 595, 636-44.

"constitutional" internal affairs rule.[26] What they seem less sure of are the precise constitutional grounds.[27] To be fair, the Supreme Court has at times gestured on the matter in equally Delphic terms. In several cases decided in the first part of the twentieth century, the Court seems to have held that full faith and credit entails the application of chartering-state law to at least some matters of internal affairs.[28] The Justices have largely ceased policing choice of law since the last of these was decided in 1935, but they have never overruled the narrow propositions for which the cases stand. And from time to time the Court continues to declare the significance of chartering-state law, albeit not in the face of argument to the contrary.[29]

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26. *See, e.g.*, *VantagePoint Venture Partners*, 871 A.2d at 1116 ("Accordingly, we hold Delaware's well-established choice of law rules and the federal constitution mandated that Examen's internal affairs, and in particular, VantagePoint's voting rights, be adjudicated exclusively in accordance with the law of its state of incorporation, in this case, the law of Delaware." (footnotes omitted)); Draper v. Paul N. Gardner Defined Plan Tr., 625 A.2d 859, 869 (Del. 1993) (observing that the internal affairs doctrine has constitutional status); *McDermott*, 531 A.2d at 217 ("[W]e conclude that application of the internal affairs doctrine is mandated by constitutional principles, except in 'the rarest situations.'").

27. In its most recent discussion of the matter, the Delaware Supreme Court espoused the view that *both* the Dormant Commerce Clause *and* the Full Faith and Credit Clause mandate the rule. Citigroup Inc. v. AHW Inv. P'ship MFS, Inc., 140 A.3d 1125, 1134 (Del. 2016) ("If the Williamses were asserting a holder claim in which they were alleging that Citigroup's officers and directors were their fiduciaries and owed them a heightened duty, that claim would be an internal affairs claim for breach of fiduciary duty. In that case, under the Commerce Clause and the Full Faith and Credit Clause, Delaware law would apply to the merits . . . ." (footnotes omitted)); *see also, e.g.*, *McDermott*, 531 A.2d at 216-17 (describing the application of the internal affairs doctrine under the commerce and full faith and credit clauses). For good measure the Delaware Court of Chancery has added the Fourteenth Amendment's Due Process Clause to the list of constitutional fonts. *See* Rosenmiller v. Bordes, 607 A.2d 465, 468 (Del. Ch. 1991) (explaining that the internal affairs doctrine "implicates federal due process, commerce clause and full faith and credit clause considerations").

28. *See, e.g.*, Broderick v. Rosner, 294 U.S. 629 (1935) (reversing the judgment of a New Jersey court applying New Jersey law to issue of stockholder liability, on the ground that New York law should have applied); Modern Woodmen v. Mixer, 267 U.S. 544 (1925) (Holmes, J.) (reversing the judgment of a Nebraska court applying Nebraska law to dispute over bylaw validity, on the ground that law of chartering state should have governed); Supreme Council of the Royal Arcanum v. Green, 237 U.S. 531, 543 (1915) (reversing the decision of a New York court applying New York law to dispute over assessment, on the ground that "the law of the State by which a corporation is created governs in enforcing the liability of a stockholder as a member of such corporation to pay the stock subscription which he agreed to make"); *see also* Reese & Kaufman, *supra* note 10, at 1129 (arguing that full faith and credit law should be read to mandate internal affairs doctrine).

29. *See, e.g.*, Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2771 (2014) (declaring that law of the charter state determines permissible corporate objectives); Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 109 n.10 (1991) (declaring that the law of the charter state determines the demand requirement in derivative litigation).

On the other hand, there are good reasons to cast the internal affairs doctrine as a mere judicial norm subject to legislative abrogation.[30] Its textual basis in the Constitution is, to be generous, slender. Corporate theory did not occupy the framers' minds, and there was little pre-ratification practice from which an unwritten norm can plausibly be inferred.[31] Certainly, the judges who elaborated the internal affairs rule in the nineteenth century did not ground it in constitutional necessity. If the doctrine is a constitutional constraint, it has become so by prescription, through long acquiescence—yet the states have never entirely played along.[32]

Notwithstanding what are largely theoretical contests over the doctrine's precise contours, the most puzzling question about internal affairs is why the doctrine exists at all—why the law cleaves the corporation's constituents the way it does. From the perspective of most modern economic theory, the sharp delineation between providers of equity capital and providers of other productive inputs, especially debt capital, is mysterious.

B. *Existing Accounts*

To the extent scholars have sought to explain or justify the doctrine, they have typically pointed to one of four functions the doctrine serves or values it advances: freedom of contract, predictability, consistency, or uniformity. None is obviously *wrong*, in the sense of being untrue. But nor does any bear a particularly close fit with the doctrine's actual contours. Below I consider these rationales in turn, as well as a further possibility—that the modern doctrine is best understood as the path dependent result of an old concern about the enforceability of equitable remedies.

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30. Most scholars who have considered the matter have reached this conclusion. *See, e.g.*, ERIN A. O'HARA & LARRY E. RIBSTEIN, THE LAW MARKET 126 (2009) ("[T]he U.S. Constitution probably does not forbid a state from regulating the internal governance of a firm that is incorporated elsewhere . . . ."); Beveridge, *supra* note 10, at 702-15; Buxbaum, *supra* note 10; Kozyris, *supra* note 4, at 33-46 (noting that a forum state may apply its own corporate law, at least where a foreign corporation's contacts predominate); Latty, *supra* note 10.

31. *See* discussion *infra* Part IV.A.

32. Judicial decisions have intermittently ignored the doctrine. *See* DeMott, *supra* note 4, at 167-72 (collecting cases); Rubenfeld, *supra* note 10, at 376 (same). Moreover, some states, most notably California and New York, still have statutes on the books that are inconsistent with the doctrine's premise. *See* CAL. CORP. CODE § 2115 (West 2014); N.Y. BUS. CORP. LAW §§ 1317-1320 (McKinney 2003); *see also* Latty, *supra* note 10 (collecting lesser-known examples). These laws purport to govern the internal relations only of select foreign corporations with extensive local ties, but they are incursions nonetheless on the theory that underlies the internal affairs rule.

1. Vindicating Voluntary Arrangements

A common explanation of the internal affairs rule imagines it as a species of freedom of contract.[33] From this view, internal affairs are unremarkable; they are but an example of a laissez-faire judiciary in action. The intuition is straightforward. When promoters seek a corporate charter—or, today, when they file articles of incorporation—they establish a shell that is nothing but the set of legal rules embodied in the charter. The corporation has no assets and conducts no activity until constituents opt in. When investors choose to contribute capital in exchange for stock, they agree to the charter's rules, which are a function of the legislative power that creates them. To substitute another state's law in disputes arising later would be to upset what are effectively contractual arrangements.

The contractual model of the corporation is useful for many purposes, but it does not supply a satisfactory account of the internal affairs doctrine. The reasons are both historical and practical. As a historical matter, the contractual paradigm cannot explain the doctrine's genesis. If when stockholders invest they agree to chartering-state law, their agreement is implicit, to be inferred from silence in reference to a background legal rule that sets expectations. But this particular background rule's origin is precisely what one wants to explain. Nineteenth-century judges could have chosen a different background rule and so created a different kind of consensual regime.[34] Moreover, as a practical matter, the internal affairs doctrine would mark a bizarrely under-inclusive rule if it was created to maximize contractual freedom in the corporate context. A satisfactory account has to explain why an investor consents to chartering-state law when she buys stock but not when she accepts a job as a rank-and-file employee. Why would laissez-faire judges articulate a rule under which managers and *equity investors* can choose their law independent of physical location but managers and *employees*, say, cannot? Plainly,

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33. Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 266 (1993); Tung, *supra* note 4, at 40.

34. For an alternative fiction of consent in the corporate context, consider the judgment in *Pinney v. Nelson*, 183 U.S. 144 (1901). *Pinney* concerned the liability of stockholders in a Colorado mining corporation for corporate debts incurred in California. At the time the company's charter was procured, California had on its books a statute imposing stockholder liability for the debts of foreign corporations. The Supreme Court held the statute constitutionally permissible as applied. The corporation's charter contemplated operating in California, and so, as Justice Brewer put it for the Court, "it must be assumed" the stockholders expected California law to apply. *Id.* at 151.

antithetical values must be taken into account—state territorial sovereignty is one. A free-floating preference for liberty of contract poorly predicts conflicts analysis in the corporate context. Corporations are fictions, and fictions are arbitrary on their face. The "free contract" rationale does not and logically cannot explain the definition of internal affairs on which implied agreement is premised. At most, it justifies courts in continuing to adhere to what are now settled expectations.

2. Increasing Predictability

A related value the internal affairs doctrine is said to vindicate is alternatively described as "certainty," "predictability," or "ease of application."[35] This the doctrine surely promotes. The identity of a corporation's chartering state is easy to determine, and the doctrine provides a clear rule not subject to a vague balancing of state "interests."

No doubt predictability is a virtue. But like all virtues, it is subject to competing values and sometimes must give way. Ironically, conflicts law, probably more than any other body of law, was during the twentieth century the subject of a full-throated contest over just such a tradeoff. The story of the Second Restatement is a story of the triumph of flexibility over certainty. If certainty were the only thing at stake in the corporate context, the internal affairs rule presumably would have gone the way of *lex loci contractus* and *lex loci delicti*.[36] Yet there is no evidence of the rule's decline. Predictability, standing alone, explains nothing. To explain the internal affairs doctrine by reference to predictability, one would need some reason to believe the rights and obligations of equity investors require certainty in a way that, for example, the rights and obligations of employees do not.

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35. *See, e.g.*, First Nat'l City Bank v. Banco Para el Comercio Exterior de Cuba, 462 U.S. 611, 621 (1983) (emphasizing "certainty and predictability of result"); Shaffer v. Heitner, 433 U.S. 186, 215 n.44 (1977) (extolling a "uniform and certain standard"); Latty, *supra* note 10, at 139-40; Reese & Kaufman, *supra* note 10; Tung, *supra* note 4, at 40.

36. Very few states still adhere to the territorially defined choice of law rules, such as *lex loci contractus* and *lex loci delicti*, which had the virtue of predictability. *See, e.g.*, Celia Wasserstein Fassberg, *Realism and Revolution in Conflict of Laws: In with a Bang and Out with a Whimper*, 163 U. PA. L. REV. 1919, 1931 (2015) (documenting changing approaches to conflicts).

3. Thwarting Inconsistency

The threat of inconsistent law is often supposed to explain the internal affairs doctrine.[37] If states other than the chartering state were allowed to dictate the terms on which stockholders and managers interact, plural regimes with plural and inconsistent rules might result. This *sounds* bad. The potential problem is in fact a small one, however, and the internal affairs doctrine does little to forestall it.

As frequently as inconsistency is cited, it is seldom explored in any detail. The asserted problem is one of multiple masters. Where plural sources of law exist, two types of inconsistency are possible. "Weak-form" inconsistency describes scenarios in which an actor faces multiple rules but can comply simultaneously with each. Take two driving laws, one declaring a maximum speed of fifty miles per hour and the other a maximum of fifty-five. Because it is possible to comply with both, by driving slower than fifty miles per hour, the scenario exhibits weak-form inconsistency. Most of the potential

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37. Delaware courts are especially fond of this explanation. *See* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1112-13 (Del. 2005) ("The internal affairs doctrine developed on the premise that, *in order to prevent corporations from being subjected to inconsistent legal standards*, the authority to regulate a corporation's internal affairs should not rest with multiple jurisdictions." (emphasis added)); Rosenmiller v. Bordes, 607 A.2d 465, 468 (Del. Ch. 1991) ("The internal affairs doctrine requires that the state that has created the corporation be the only state whose law controls the relationships among the corporate entity, directors, officers and stockholders. This concept implicates federal due process, commerce clause and full faith and credit clause considerations *because in the absence of such a rule, a corporation would be subject to the risk of inconsistent judgments by virtue of its being amenable to service of process in different jurisdictions*." (emphasis added)); *see also* Edgar v. MITE Corp., 457 U.S. 624, 645-46 (1982) ("The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—*because otherwise a corporation could be faced with conflicting demands*." (emphasis added)); Rogers v. Guaranty Tr. Co., 288 U.S. 123, 130 (1933) ("It has long been settled doctrine that a court—state or federal—sitting in one State will as a general rule decline to interfere with or control by injunction or otherwise the management of the internal affairs of a corporation organized under the laws of another State but will leave controversies as to such matters to the courts of the State of the domicile."); N. State Copper & Gold Min. Co. v. Field, 20 A. 1039, 1041 (Md. 1885) (Bryan, J., dissenting) (stating that courts clearly possess no power to regulate the internal affairs of a foreign corporation); DeMott, *supra* note 4, at 161 (noting that the idea that the state of incorporation has the exclusive power to regulate the relationships among a corporation and its officers, directors, and shareholders is the only logical conclusion to many corporate lawyers); Latty, *supra* note 10, at 143 (collecting cases involving internal affairs of a corporation chartered in a foreign state as one of three groups of cases that look exclusively to the law of the state of incorporation); Tung, *supra* note 4, at 57, 67 ("[S]ome courts recognized that *the jurisdictional bar avoided subjecting corporations to conflicting decisions and inconsistent obligations*." (emphasis added)).

inconsistencies in the law of corporate management are of this type. For example, one jurisdiction may impose a more exacting corporate opportunities rule than another. One jurisdiction may be more willing than another to entertain derivative suits, perhaps because its judges are more apt to think stockholder demands "futile." And so on. The differences are matters of degree. Weak-form inconsistency cannot explain the internal affairs doctrine, if only because this kind of inconsistency is a staple of American law.[38] It is the rule rather than the exception. Modern conflicts analysis rests on the notion that more than one jurisdiction will often have "interests" sufficient to ground the application of its law. A person must decide whether to gamble that the more lenient rule will be applied *ex post* to his case or else to take the conservative course and comply with the more restrictive rule. Nothing about the stockholder-manager relation is obviously special.

"Strong-form" inconsistency describes a scenario in which an actor cannot comply with each of multiple rules. Take a different pair of driving laws, one declaring a maximum speed of fifty miles per hour and the other a *minimum* of fifty-five. Because it is impossible to honor both, this scenario exhibits strong-form inconsistency.[39] The prospect of strong-form inconsistency is a better explanation of the internal affairs doctrine, at least at first glance. Law tends to adopt rules, even arbitrary rules, if they can prevent latent cycling opportunities.[40] But for at least three reasons, even strong-form inconsistency does not provide a satisfactory account.

First, strong-form inconsistency characterizes only a small fraction of the kinds of rules that are typically litigated. Inconsistency in the law of, say, corporate opportunities or standards of care or financial policy, is likely to be of the weak-form kind. Rules are likely to conflict, if at all, only in the extent of judicial skepticism they prescribe. They are unlikely to conflict on *whether*, say, embezzlement is lawful. The most important exception, where strong-form inconsistency would be possible absent the internal affairs rule,

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38. Under the Supremacy Clause, rules inconsistent with federal law in this weak-form sense are preempted only if Congress has "occupied the field." *See* Gade v. Nat'l Solid Wastes Mgmt. Ass'n, 505 U.S. 88, 98 (1992). The courts generally tolerate multiple, weak-form inconsistent rules.

39. Rules inconsistent with federal law in the strong-form sense are preempted by "conflict." *See* Fla. Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963).

40. For discussion of strategies used to prevent cycling, see generally LEO KATZ, WHY THE LAW IS SO PERVERSE (2011); Saul Levmore, *Public Choice and Law's Either/Or Inclination*, 79 U. CHI. L. REV. 1663 (2012) (reviewing KATZ, *supra*).

concerns stockholder voting rules. If two states require inconsistent aggregation rules and the votes cast in a particular contest would result in differing outcomes under the two rules, the result could in principle cause long-term chaos.[41] But although voting rules are important, they are, practically speaking, a small part of corporate law. The strong medicine of the internal affairs doctrine is hard to justify in functional terms of this kind. And certainly, as a historical matter, the doctrine did not in fact emerge in response to disputes involving inconsistent voting rules.[42] Rather, it emerged in cases concerning corporate financial policy and, to some extent, operational policy.[43] It would have been easy for courts to defer to the chartering state in the limited class of cases presenting the prospect of cycling. This is not what happened, however.

Second, the magnitude of harm inconsistent voting rules could pose would likely be small, even where cycling is conceptually possible, because preclusive rules are ubiquitous.[44] A recent case provides a useful illustration. *VantagePoint Venture Partners 1996 v. Examen, Inc.* concerned the appropriate aggregation scheme for a merger vote.[45] Examen's directors wished to merge the company with an acquirer, a fundamental change requiring investors' consent. The vote's outcome was to depend on the classification of preferred stock. Examen's common stockholders approved overwhelmingly of the merger, but a preferred stockholder balked. Under Examen's articles and the law of Delaware, where the company was incorporated, the preferred stockholder would be counted alongside the common stockholders, who would prevail. But Examen was sufficiently connected to California that, according to *its* law, California's voting

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41. For a more detailed explanation, see DeMott, *supra* note 4, at 175-76 (arguing that *some* uniform choice-of-law rule is needed to prevent incoherence, as when two states require mutually exclusive voting rules).

42. *See* discussion *infra* Part IV.C.

43. *See* discussion *infra* Part IV.C.

44. *See, e.g.*, Note, *The Development*, *supra* note 21, at 416 & n.14 ("The possibility of divergent results in these situations appears to have been over-emphasized. The internal affairs problem is ordinarily raised by a stockholder's derivative suit which is frequently a representative action whose result is *res judicata* for all persons who may later seek to litigate the same issues.").

45. 871 A.2d 1108 (2005). By cycling I mean the propensity for the courts of *Jurisdiction A* to provide relief inconsistent with the law of *Jurisdiction B*, whose courts will therefore provide further relief inconsistent with the law of *A*, and so on ad infinitum. For extended, illuminating discussions of the cycling problem and law's responses, see generally KATZ, *supra* note 40; Levmore, *supra* note 40.

rules were mandatory.[46] Under California law, the preferred stockholder would be separately classified and so hold an effective veto. It was a clear case of strong-form inconsistency. Delaware law required the merger; California law prohibited it. But in the event, there was no cycling. The preferred stockholder filed suit in California. Examen's directors responded by seeking a declaration from the Court of Chancery. Because Delaware was first to judgment, its rule prevailed, and the merger went through. Now, strong-form inconsistency does of course lead to uncertainty in the substantive law, even with preclusive rules in place. But as we have seen, uncertainty does not explain the internal affairs rule.

Third, the internal affairs rule does not as a matter of course prevent strong-form inconsistent rules from saddling corporations that do business across jurisdictional lines. The reason is easy to see. To say that states other than the chartering state cannot regulate stockholder-manager relations is to acknowledge that they can regulate other constituents' claims against corporate assets. This is not controversial. But if a manager's decision about the deployment of corporate resources affects stockholders as well as other constituents, as nearly all decisions are bound to do, the conditions for inconsistency are satisfied. The chartering state may give stockholders a claim if condition *P* is met, while a host state may give another constituency a claim if condition -*P* is met. Inconsistent rules of this kind have been rare, but they have been rare on account of practice, not impossible on account of the logic of internal affairs.[47]

4. Treating Stockholders Uniformly

Commentaries sometimes declare the internal affairs doctrine necessary to secure the uniform treatment of a corporation's stockholders.[48] Why uniformity of this particular kind is important is not so much explained as assumed. It has the ring of sound policy, to

46. Recall that California rejects some applications of the internal affairs rule. *See supra* note 32.

47. In practice, most corporate law frames managerial obligations in terms of residual discretion—how to behave given the constraints imposed by territorial law. Most territorial law, on the other hand, frames corporate obligations in terms of constraints and does *not* address discretion, even though in many cases the difference is nominal rather than substantive. As long as this practice remains stable, no conflict is formally possible, but it is important to see that the internal affairs rule does not entail the practice.

48. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 303 cmt. d (AM. LAW INST. 1971); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2403 (1998); Tung, *supra* note 4, at 40.

be sure. "Like cases should be treated alike." If one had only six words to define justice, these would be plausible candidates.[49] A company's stockholders are of course similarly situated along an important dimension. But stockholders residing in different jurisdictions are also differently situated along the dimension of residence. Because discrimination according to state of residence is commonplace in a federal legal system, invoking the principle of likeness proves too much. If stockholder uniformity is supposed to motivate or justify the internal affairs doctrine, one must address why stockholder uniformity, in particular, merits deviation from the background norm that legal rights depend on location. Put differently: If all of a corporation's stockholders should be treated the same, wherever they reside, as a basic matter of justice, then one has to explain why other corporate constituents do not likewise deserve uniformity. An explaination of why the accident of geography is irrelevant to stockholders but relevant to employees and customers and vendors and creditors is warranted. As it happens, there is a good reason why stockholders are special—or so in any event is my thesis. But the unadorned admonition that stockholders be treated alike will not do.

5. The Futility of Equitable Remedies

A more intriguing explanation of the genesis of the internal affairs rule is rooted in the historic distinction between law and equity jurisdiction.[50] In the framework of nineteenth-century American law, a corporation's contract counterparties and tort victims typically found their remedies in the law courts—or on the law side of merged courts. If they could establish personal jurisdiction outside the chartering state, they could procure a judgment valuable wherever the company's assets might be found, including in the chartering state.[51] Stockholders, by

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49. H.L.A. HART, THE CONCEPT OF LAW 159-62 (2d ed. 1994); ARISTOTLE, NICOMACHEAN ETHICS bk. V, at iii (G.P. Goold ed., H. Rackham trans., Harvard Univ. Press rev. ed. 1934) (c. 384 B.C.E.). *But see* David A. Strauss, *Must Like Cases Be Treated Alike?* (Univ. of Chi. Law Sch., Working Paper No. 24, 2002), https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1197&context=public_law_and_legal_theory (arguing otherwise).

50. Some of the judges who developed the internal affairs doctrine gestured in this direction, even if they did not say precisely what their view entailed. *See, e.g.*, Howell v. Chi. & N.W. Ry. Co., 51 Barb. 378, 383 (N.Y. Sup. Ct. 1868); Williston v. Mich. S. & N. Ind. R.R. Co., 95 Mass. (13 Allen) 400, 406 (1866).

51. *See* discussion *infra* Part IV. In 1813, the Supreme Court held that Full Faith and Credit Clause entailed each state giving such effect to the judgments of sister states as the judgment would have had in the rendering state. Mills v. Duryee, 11 U.S. (7 Cranch) 481

contrast, found their remedy against managerial expropriation in the equity courts.[52] According to at least some authorities, equity decrees, unlike legal judgments, did not merit full faith and credit in sister states courts.[53] One way to understand the internal affairs doctrine, then—at least the part involving adjudicatory jurisdiction—is as a practical recognition of the weakness of equity in the American system.[54] From this perspective, the nineteenth-century judiciary described cases that invoked law jurisdiction, where judicial power was robust, as involving

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(1813). So long as the rendering court had jurisdiction over both the defendant's person and the action's subject matter, its judgment was conclusive across the country. *Cf.* D'Arcy v. Ketchum, 52 U.S. (11 How.) 165, 176 (1850) (rendering judgments without jurisdiction void).

52. A line of cases from New York established equity's authority most clearly. *See* Robinson v. Smith, 3 Paige Ch. 222, 232 (N.Y. Ch. 1832) (entertaining a bill by minority stockholders claiming oppression by majority); Verplanck v. Mercantile Ins. Co. of N.Y., 2 Paige Ch. 438, 451 (N.Y. Ch. 1831) (noting that stockholder bills were frequently before the court); Ogden v. Kip, 6 Johns. Ch. 160, 161-62 (N.Y. Ch. 1822) (entertaining a bill by stockholders seeking to enjoin directors from continuing to manage the corporation); Att'y-Gen. v. Utica Ins. Co., 2 Johns. Ch. 371, 389-90 (N.Y. Ch. 1817) (Kent, Ch.) ("I admit, that the persons who, from time to time, exercise the corporate powers, may, in their character of trustees, be accountable to this Court for a fraudulent breach of trust . . . ."). But New York was not alone. *See, e.g.*, Bayless v. Orne, 1 Freeman's Ch. 161, 161 (Miss. Ch. 1840); Taylor v. Miami Exporting Co., 5 Ohio 162, 165 (1831); Langolf v. Seiberlitch, 2 Pars. Eq. Cas. 64, 66 (Pa. Com. Pl. 1851); Putnam v. Sweet, 2 Pin. 302, 315 (Wis. 1849); *see also* Bert S. Prunty Jr., *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980, 985-92 (1957) (describing the evolution of shareholders' derivative suits).

53. Unlike at law, the plaintiff in equity sought an order directing the defendant to do—or refrain from doing—some action. Some decrees might be satisfied by the defendant's payment of a certain sum to plaintiff, like a judgment. But the theory underlying judgments and decrees was very different. While the judgment was said to work *in rem*, the decree operated *in personam*. Its force lay in an implicit threat to jail the contemptuous defendant until he performed of his own volition. *See, e.g.*, C.C. LANGDELL, A SUMMARY OF EQUITY PLEADING 35 n.4 (Cambridge, Charles W. Sever & Co. 1883) (1877); EDWARDO COKE, THE FOURTH PART OF THE INSTITUTES OF THE LAWS OF ENGLAND 84 n.3 (William S. Hein & Co., Inc. 2008) (1797). This the court could do, however, only if its process could reach the defendant. Thus, into the twentieth century, Joseph Beale propounded the view that decrees were absolutely without effect outside the court's territorial jurisdiction. 3 JOSEPH HENRY BEALE JR., A SELECTION OF CASES ON THE CONFLICT OF LAWS 536-37 (1902).

54. Some courts explained their decisions on this basis. *See, e.g.*, Sauerbrunn v. Hartford Life Ins. Co., 115 N.E. 1001, 1004 (N.Y. 1917) ("The order and decree of the court in this state has no extraterritorial effect or force."); Taylor v. Mut. Reserve Fund Life Ass'n of N.Y., 33 S.E. 385, 388 (Va. 1899) ("Courts other than those of the state creating [a corporation] . . . . have [no] power to compel obedience to their orders nor to enforce their decrees."); *Howell*, 51 Barb. at 383 ("[W]hen we remember the utter inability of the courts to enforce any other remedy beyond the bounds of the state, it will be apparent that such litigation [seeking to compel action by directors of foreign corporations] will in most cases prove useless."); *Williston*, 95 Mass. (13 Allen) at 406 ("We have no power to control the action of the company, and no means of securing obedience to any injunction or other decree."); *cf.* State *ex rel.* Wurdeman v. Reynolds, 204 S.W. 1093 (Mo. 1918) (finding equity jurisdiction where foreign corporation's assets and officers were in Missouri, on the ground that a decree, unlike in many foreign-corporation cases, would be effective).

third-party relations, and described cases invoking equity jurisdiction, where power was more doubtful, as involving the corporation's "internal affairs."

Appeals to futility carried at least some weight for nineteenth-century judges. But however tempting it might be to chalk up the internal affairs rule to a gloss on equity practice, the account is ultimately flawed. It suffers from two major defects. The first is its premise—equity's impotence across state lines. Ancient authorities notwithstanding, judges in the aftermath of the Civil War had good reason to think many if not all decrees they might issue would be respected in sister states' courts. In *Pennington v. Gibson*, decided in 1853, the Supreme Court held that full faith and credit is due decrees for the payment of money.[55] Many internal affairs claims are about just that. More generally, *Pennington*'s rationale was hard to square with the notion that decrees are less effectual than judgments. The decision supplied no theoretical basis to distinguish decrees for the payment of money from decrees for the doing of any other act.[56] If one kind of decree merited full faith and credit, there was no clear reason why another did not. Indeed, the Court suggested as much:

> We hold no doctrine to be better settled than this, that whenever the parties to a suit and the subject in controversy between them are within the regular jurisdiction of a court of equity, the decree of that court solemnly and finally pronounced, is to every intent as binding as would be the judgment of a court of law, upon parties and their interests regularly within its cognizance.[57]

State courts in this period were in fact crediting foreign decrees beyond those for the payment of money. In the well-known case of *Dobson v. Pearce*, decided in 1854, a New York court held it was bound by a Connecticut court's anti-suit decree.[58] The decree lacked direct force in New York, but it precluded relitigation of the issues it adjudicated. Likewise many courts recognized the preclusive effect of foreign

55. 57 U.S. (16 How.) 65, 77 (1853) ("We lay it down, therefore, as the general rule, that in every instance in which an action of debt can be maintained upon a judgment at law for a sum of money awarded by such judgment, the like action can be maintained upon a decree in equity which is for an ascertained and specific amount . . . .").

56. *See* Willard Barbour, *The Extra-Territorial Effect of the Equitable Decree*, 17 MICH. L. REV. 527, 543 (1919) ("The decree assumes substantially the same form whether it be for the payment of money or the conveyance of land . . . ." (footnote omitted)).

57. *Pennington*, 57 U.S. (16 How.) at 76.

58. 12 N.Y. 156 (1854) (recognizing that Connecticut anti-suit decree, although lacking direct effect in New York, nevertheless had issue preclusive effect in New York courts).

decrees for the conveyance of land.[59] Not every kind of decree an equity court might issue in an internal affairs case would obviously be respected, but as the great Brainerd Currie was to put it, "*some* equity decrees, at any rate, create obligations."[60]

Moreover, the equity courts knew how to cajole performance when they wanted to, even if a prospective decree really would have lacked extraterritorial effect. This was no secret. As the Supreme Court explained in an 1854 opinion, equity courts were in the habit of achieving their ends, whatever the details of their jurisdiction, "by the coercion of the person and sequestration of his property [locally situated]."[61] Prison motivates compliance. And whatever the basis in theory, equity courts in the nineteenth century in fact regularly issued decrees for the accomplishment of extraterritorial acts. As early as the 1840s, Justice Story remarked in his *Commentaries* on this distinctively American practice.[62] None of this is to suggest that declarations of judicial impotence were entirely illusory. What it does suggest, however, is that something else may have been going on in the internal affairs cases.

The second defect in the futility account goes to its punchline. Doubt about the enforceability of decrees, even if taken at face value, can explain only the component of internal affairs related to adjudicatory jurisdiction. It cannot explain the doctrine's choice-of-law component, which survives intact a century after jurisdictional doubt dissolved. The futility account is all about which disputes a host state's courts will hear. It says nothing about the authority to prescribe rules governing the relationships of corporate constituents. But as early

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59. *See* Ernest G. Lorenzen, *Application of Full Faith and Credit Clause to Equitable Decrees for the Conveyance of Foreign Land*, 34 YALE L.J. 591, 593-96 (1925) (collecting cases).

60. Brainerd Currie, *Full Faith and Credit to Foreign Land Decrees*, 21 U. CHI. L. REV. 620, 623 (1954).

61. Booth v. Clark, 58 U.S. (17 How.) 322, 333 (1854).

62. JOSEPH STORY, COMMENTARIES ON THE CONFLICT OF LAWS § 544 (Lawbook Exchange, Ltd. 2001) (1841); *see also* Polly J. Price, *Full Faith and Credit and the Equity Conflict*, 84 VA. L. REV. 747, 802-04 (1998) (collecting authorities to this effect from the second half of the nineteenth century). Price cites the example of an 1862 decision out of Massachusetts, in which it was declared "clear and indisputable" that domestic equity courts could "restrain" persons over whom they had jurisdiction from doing injurious acts abroad. *Id.* (citing Dehon v. Foster, 86 Mass. (4 Allen) 545, 550 (1862)); *see also, e.g.*, Pierce v. Equitable Life Assur. Soc. of U.S., 12 N.E. 858, 863-64 (Mass. 1887) (explaining that Massachusetts courts will issue a decree against a foreign corporation even where none of its directors, books, or assets were within territorial reach, because "[w]e shall not assume that [the corporation] will neglect any order that we may pass, nor indicate how such order may be enforced").

as the 1860s, courts were declaring that the law of the chartering state, not of the forum, determines a stockholder's liability to assessment or for corporate debts.[63] The "futility" account of internal affairs cannot explain this.

III. OPPORTUNISTIC MOVEMENT AND CAPITAL LOCK-IN

By the close of the nineteenth century, the corporation was unrivaled as the principal organizational form for large-scale, capital-intensive industry in the United States.[64] Economic historians differ on this fact's significance. Some think the widespread availability of incorporation catalyzed economic development in the late-nineteenth and twentieth centuries.[65] Even if, as others believe, the corporate form was not strictly necessary to growth in much of the economy, it probably was instrumental in the development of at least some sectors.[66] But whether the corporation's popularity was cause or consequence of economic growth, the fact is it became the dominant mode of organization.[67]

A leading explanation for this fact is that the corporation allows entrepreneurs to lock in capital investments.[68] The lock-in hypothesis says the corporation came to the fore in capital-intensive industries because, unlike other modes of coordination such as partnership or contract, it could prevent capital providers and others standing in their shoes from withdrawing their investments and forcing inefficient

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63. *See, e.g.*, Merrimac Mining Co. v. Levy, 54 Pa. 227, 230 (1867) (resolving a dispute concerning the assessment of stock by a Michigan corporation against a Pennsylvania resident, and applying Michigan law to resolve the dispute); discussion *infra* Part IV.

64. *See* Blair, *supra* note 13, at 389 n.3 (providing evidence that the number of chartered American businesses grew from approximately 335 in 1800 to half a million by the century's close).

65. *See, e.g.*, NATHAN ROSENBERG & L.E. BIRDZELL JR., HOW THE WEST GREW RICH: THE ECONOMIC TRANSFORMATION OF THE INDUSTRIAL WORLD (1986).

66. Timothy Guinnane et al., *Putting the Corporation in Its Place*, 8 ENTERPRISE & SOC'Y 687, 689 (2007).

67. Naomi R. Lamoreaux, *Constructing Firms: Partnerships and Alternative Contractual Arrangements in Early Nineteenth-Century American Business*, 24 BUS. & ECON. HIST. 43, 44 (1995) ("[A]s the domestic market grew large and it became profitable to invest in large-scale, capital-intensive technology, firms shifted from the partnership to the corporate form in order to increase their ability to raise funds.").

68. *See, e.g.*, Lamoreaux & Rosenthal, *supra* note 13; Blair, *supra* note 13; Hansmann et al., *supra* note 13. *But see* Morley, *supra* note 13 (denying the uniqueness of the corporation in this respect); Andrew Verstein, *Enterprise Without Entities*, 116 MICH. L. REV. 247, 294-95 (2017) (denying the importance of entities in at least some capital-intensive industries).

liquidation.[69] Firms operating in industries that require deployment of large amounts of specific physical capital can thrive only if they can ward off liquidation threats. Pooling assets under a corporate name lessens the threat. Equity investors, in exchange for relinquishing immediate control of their capital, get primarily a suite of contingent rights—to share in dividends, to block *ultra vires* acts, and to oust scurrilous or incompetent directors. The value of the corporate arrangement inevitably turns, however, on just what kind of balance of power is struck between stockholders and management. Insulating managers too completely invites self-dealing and sloth. Giving them too little authority, on the other hand, effectively duplicates the at-will partnership. Optimal capital lock-in is a matter of degree.

Capital lock-in helps explain the otherwise puzzling contours of the internal affairs doctrine. This Part argues that something like the internal affairs rule was and is needed to achieve lock-in in a world characterized by a national economic market but a federal political system. The basic problem involves an investor's incentive to expropriate from other parties by moving to a privately favorable legal regime after the price of investment has been agreed. My argument is that stockholders are special—not in the sense that law ought to privilege their interests, but because they are, or at least historically have been, uniquely situated to undermine corporate organization through opportunistic movement. Without the internal affairs rule, or a close equivalent, the prospect of inefficient liquidation and attendant hold-up threats would sharply reduce the value of the corporation as a coordinating mechanism. The doctrine can thus be understood as an adaptation that maximally preserves states' autonomy subject to the constraint that autonomy not undermine the corporation's ability to lock in capital.

A. Stockholders

Capital lock-in helps prevent an enterprise's inefficient liquidation. At common law, the partnership was subject to dissolution at any partner's say-so. This was perhaps not a catastrophe when most partnerships comprised only two or three or, at most, a handful of partners bound by social as well as legal conventions. But the threat of untimely dissolution increases in a nonlinear fashion with the number

69. *See, e.g.*, Lamoreaux & Rosenthal, *supra* note 13; Blair, *supra* note 13; Hansmann et al., *supra* note 13. *But see* Morley, *supra* note 13; Verstein, *supra* note 68.

of partners. Ventures requiring lots of equity investment to achieve efficient scale are ill suited to the common-law rule. In theory, investors could contract around the at-will partnership by specifying a durable arrangement. But throughout the nineteenth century there was real doubt about the enforceability of such modifications, at least by specific performance.[70] Moreover, even if courts were to enforce the durable partnership against the partners themselves, there was no good way to stop the partners' personal creditors or heirs from levying on enterprise assets in a manner that would threaten the enterprise's value as a going concern.[71] If asset specificity characterizes an enterprise,[72] and refinancing is costly, then one investor's ability to withdraw capital unilaterally threatens all other investors and can be used as holdup leverage.[73]

But lock-in creates problems of its own—it invites managerial misbehavior. At the extreme, lock-in creates a regime under which investors are totally at the mercy of sitting managers. This is why the corporation has never fully shielded capital from stockholders' claims. Every jurisdiction gives stockholders rights by which they can influence the disposition of enterprise assets. They can try to oust management. They can try to enjoin prospective deals. They can sue retrospectively for waste, self-dealing, or mismanagement. Balance is the watchword, and it accounts for the plausibility of a variety of legal orders ranging from the most "managerial"—weak stockholder control

70. *See* Lamoreaux & Rosenthal, *supra* note 13, at 130-33 (citing conflicting authorities).

71. Blair, *supra* note 13; Hansmann & Kraakman, *supra* note 9.

72. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298 (1978).

73. Inefficient discontinuation would be unimportant if financial markets operated costlessly because a new investor's capital could replace whatever is withdrawn. This insight is at the core of Douglas Baird and Robert Rasmussen's work on the significance of collective reorganization processes in the modern economy. *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002). As they point out, a mandatory mechanism makes sense only if (1) an enterprise is likely to have going-concern value (asset specificity) and (2) it is infeasible to refinance the enterprise, either through informal negotiation among investors or a sale of the business. Although Baird and Rasmussen focus on bankruptcy, their observation has clear implications for the law of corporate finance more generally. In particular, the threat of inefficient discontinuation varies with the cost of refinancing. When issuing securities is expensive and time consuming, a threat to withdraw capital may well be a threat to destroy value, and so rules requiring costly cooperation can make sense. When raising capital is cheap, on the other hand, the benefits of mandatory cooperation are small, and its costs predominate.

and withdrawal rights—to the most "interventionist"—strong stockholder control and withdrawal rights.

If the internal affairs doctrine had not emerged to root stockholders' rights and obligations to a single state and if, instead, a rule of territorial variation had prevailed, a collective-action problem might have undermined the corporation's capital lock-in function. To illustrate the intuition, consider a simple model. Suppose there are two states, "managerial" (*MA*) and "interventionist" (*IN*). Each has a well-developed body of law concerning stockholder rights and obligations. *MA*'s law gives stockholders relatively weak rights against management—or against the assets *under management*: large supermajorities are needed to compel corporate acts, courts are unwilling to entertain derivative litigation, and appraisal is strictly limited. *IN*, on the other hand, gives stockholders relatively strong rights. Each state freely charters corporations capable of accessing markets in the other state, and entrepreneurs in fact take advantage of this power—so that both states can assert personal jurisdiction. As an initial condition, all corporate stock is issued to residents of the chartering state, and residents are subsequently free to trade and move across state lines. But there is no equivalent to the internal affairs rule. Territorial law governs stockholder claims, and in particular the decisive fact is the place where the effects of corporate acts or omissions are felt.[74]

What happens to stock ownership in equilibrium? Setting aside capital constraints, the stock of *IN* corporations remains in *IN*, and the stock of *MA* corporations flows into *IN*. The magnitude of the flow depends on the relationship of two variables: (1) the expected value of a share's optionality in *MA* compared to *IN*, i.e., the marginal value of the optionality *IN* grants, and (2) the mobility cost of trading a share between the jurisdictions. The first variable is a measure of the value to a stockholder of the control and withdrawal rights associated with interventionist law. Whatever the merits of a managerial regime for the

74. This simplifies somewhat the rule a counterfactual conflicts law would supply, but it is not far from the mark assuming, additionally, that stockholders always bring suit in their own domestic courts. Conflicts analysis has long given preeminence to the place where a tortious injury is alleged to have been suffered. *See, e.g.*, RESTATEMENT (FIRST) OF CONFLICT OF LAWS § 377 note 4 (AM. LAW INST. 1934) (explaining that, when loss is suffered due to fraud, the wrong occurs where the loss is suffered). A modern observer is apt to think contract rather than tort the relevant benchmark; such has been the success of contractarian theories of the firm. But in the nineteenth century, allegations of corporate mismanagement were generally allegations of fraud, because the theory was a breach of trust rather than failure to perform a particular, bargained-for action.

total value of an enterprise, each individual share is worth more if it confers on its owner greater rights. The situation describes a basic social dilemma. As the difference between the substantive content of the two states' law increases, so does the incentive to sell stock into *IN*. The second variable refers to the transaction cost of switching legal regimes. It stands for the lesser of the cost of the owner moving and the owner selling his stock across the state border. At the limit, where the mobility cost of moving stock is zero, all shares flow into *IN*. Its law becomes the universal law of stockholder relations, and interventionist policy dominates. The degree to which capital is locked into the enterprise diminishes.

From this perspective, there are at least two interacting ways to think about the value of the internal affairs rule—one static, one dynamic. First, the rule promotes selection of the most efficient law from the set of available regimes. Begin with the observation that one cannot judge a priori whether *IN* or *MA* supplies the better law. For one thing, firms differ, and industry-specific considerations might point to a more or less interventionist regime. Even if firms were homogeneous, ranking the states' laws a priori would produce ambiguous results because capital lock-in is to be optimized, not maximized or minimized. Suppose that for two identical competitors in a particular industry there is a fifty percent chance that *IN* law is superior and a fifty percent chance that *MA* law is. One company is chartered in each state. Absent the internal affairs doctrine, if capital is unconstrained and the mobility cost of trading shares is zero, the shares of both companies will flow into *IN*, and *IN* will effectively govern stockholder rights and obligations. In expectation, the efficient result will be achieved half of the time. The other half of the time, both firms will face an inefficiently high cost of capital. Now consider the result with the internal affairs doctrine in place. *IN* law governs one set of stockholders and *MA* law the other. One or the other firm—one cannot know which a priori—will be subject to inefficient law and will therefore face higher capital costs and by extension a disadvantage in product and factor markets. In a competitive environment, the internal affairs rule selects for the better law even if an observer is ignorant ex ante about which law is superior.

Notice, too, that the magnitude of the doctrine's selection effect can be expected to increase with the number of jurisdictions. Increase the number of states from two to fifty, and suppose that each has a distinctive body of stockholder law that can be arrayed roughly from most managerial to most interventionist. Increasing the number of states simultaneously decreases the likelihood that *IN* will have the best law—from a prior of fifty percent to two percent—and increases the expected magnitude of difference between the optimal and the most interventionist law in any given case.

Second, the internal affairs rule constrains inefficient, dynamic legal change. In the model developed above, shares move from *MA* to *IN* because the buyer and seller generate a private surplus from the trade. Their surplus is equal to the value of the share's marginal optionality in *IN*, minus transaction costs. Thus, the bigger the difference in magnitude between *MA* and *IN* law, the bigger too will be the surplus the buyer and seller split. Here is the making of an unorthodox "race to the bottom."[75] Because potential stock buyers in *IN* capture greater private benefits as *IN* law becomes increasingly interventionist relative to *MA*, they may actively seek legal change. At least in the near-term, *IN*'s legislature benefits its own capitalists by adopting more interventionist policies, whether or not they are efficient.[76] The internal affairs doctrine cabins the incentive to innovate in this way.

In the conventional telling of the "race to the bottom" story, managers choose law that provides inefficient, *managerial* rules and so are able to expropriate from investors. Absent the internal affairs doctrine, it is the stockholders who choose inefficient, *interventionist* rules. The conventional race to the bottom story faces market-oriented objections because managers must choose their law before capital contributions are priced. In the story told here, by contrast, there is no obvious market corrective because movement happens after equity is issued. The internal affairs doctrine solves the collective-action problem by dictating that each stockholder's control and withdrawal

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75. One way out of the problem would be to eliminate the secondary market—increasing mobility costs to infinity. That would reduce the liquidity of investment intolerably. And indeed, the free transferability of corporate stock was by the 1880s already recognized as a principal reason the corporation was successful in attracting capital. WILLIAM W. COOK, A TREATISE ON THE LAW OF STOCK AND STOCKHOLDERS § 331 (New York, Baker, Voorhis & Co. 1887).

76. To be sure, the legislature will face a limit because potential initial investors can forecast, albeit imperfectly, and will not willingly invest into expropriation. Without making what seem to be unwarranted assumptions about rationality and foresight, no particular equilibrium can be confidently predicted.

rights be identical irrespective of the law of the state in which the stock is held.[77]

B. Other Constituents

Opportunistic movement explains not only why a single jurisdiction's law must govern stockholders but also why the law governing other corporate constituents need not be uniform. The reason is that two distinctive features of equity ownership drive the collective-action problem: mobility and investment specificity. Shares of stock are cheap to sell across state borders and also represent an input—physical capital—that must often be deployed in an enterprise-specific manner. Absent either feature, the internal affairs doctrine would be unnecessary, and territorial law could govern without problem.

If, for example, trading shares across jurisdictional lines were expensive, a stockholder's opportunity to exploit other constituents would disappear.[78] Legal variation across jurisdictions might imply different prices for equity in different jurisdictions, but the variation could be impounded in the stock price at issuance. Capital would be costlier in some jurisdictions and cheaper in others. Opportunistic movement would not however threaten enterprise viability. Likewise, an enterprise not depending on specifically invested capital would not face stockholder opportunism.[79] It is only the need for a durable relationship that begets holdup. Without the need for durable investment, the enterprise could simply cut ties with a capital supplier seeking to change terms opportunistically.

In the context of the typical corporate enterprise, inputs other than equity capital typically lack—or at least historically have lacked—either mobility or specificity or both. Therefore, entrepreneurs are able to tolerate legal diversity in labor and other factor markets reasonably well. Sometimes the reasons are technological, sometimes institutional. Either way, territorial law does not give rise to opportunistic movement

77. Note that a "real seat" doctrine, such as prevails in Europe, would accomplish this equally well. But managers can manipulate the real seat *ex post*; a corporation can be rechartered only with the consent of a super-majority of stockholders.

78. One could even describe the internal affairs rule as doing nothing but artificially raising to infinity the price of "trading up" optionality.

79. For extended discussion of the relationship between industrial requirements and the treatment of capital providers, see generally HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996).

in the way it would absent the internal affairs rule for stockholders. Consider the most important examples:

1. Financial Creditors

Financial creditors pose the most obvious challenge to the argument. According to modern principles of corporate finance, debt and equity investments are simply two flavors of financial investment. Lenders can be numerous and widely dispersed, like stockholders. In principle, secondary debt markets can be as liquid as stock markets. The combination of dispersed investors and liquid markets should, it might seem, point toward destructive opportunism among bondholders on par with stockholders. The puzzle, then, is why internal affairs are not defined to embrace the rights and obligations of debt as well as equity capital providers.

An answer is that courts have never needed such a coordination rule, because debtor-creditor law has always been relatively uniform across the country. Creditor opportunism was not a significant concern when the internal affairs doctrine was being developed. When the specter of creditor holdout—and thus opportunism—finally did appear with the railroad failures of the late-nineteenth century, the combination of background legal norms supplied by the general law and the availability of federal fora meant that substantive rules were largely uniform across the country and difficult to change.[80]

In the 1860s, when the courts fashioned the internal affairs doctrine, tradeable corporate debt was still highly unusual. The banking sector developed rapidly in the late-eighteenth century.[81] Firms in need of debt capital naturally looked to local banks rather than to bond markets. Indeed, for more than half a century after the American Revolutionary War, traded debt securities were the province of governments alone.[82] Private bonds were a comparatively late development, with railroads, as usual, being the innovators.[83] Mortgage

80. *See* Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 BUS. HIST. REV. 1 (1997).

81. NAOMI R. LAMOREAUX, INSIDER LENDING: BANKS, PERSONAL CONNECTIONS, AND ECONOMIC DEVELOPMENT IN INDUSTRIAL NEW ENGLAND 13 (1994).

82. *See, e.g.*, Richard Sylla, *U.S. Securities Markets and the Banking System, 1790-1840*, REV., May/June 1998, at 83, 91 (showing numerous government issues but no corporate bonds among securities traded on exchanges between 1797-1817).

83. Bank credit sufficed for some time to provide what private debt was needed, even in the railroad context. Richard Sylla, *A Historical Primer on the Business of Credit Ratings*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 19 (Richard M. Levich et al. eds., 2002); Jonathan Barron Baskin, *The Development of Corporate Financial Markets in*

bonds eventually became a common way to finance the western railroads, but that was not until after 1850.[84] Even then, bond debt remained largely unknown outside the railroads.[85] In short, corporate debt just was not as mobile in the mid-nineteenth century as a modern observer might suppose.

When companies finally did begin borrowing regularly in the bond markets, the prospect of opportunistic movement might have become reality. The reason it did not is due largely to the fact that the relevant substantive law was more or less uniform across the country. That law, especially the law of fraudulent conveyance, made it difficult for creditors to hold up operations as long as a debtor paid its bills. In particular, unsecured creditors were universally understood to lack equity in the borrower's assets before default. A debtor could dispose of assets freely, without fear of holdup, until the creditor had won a judgment and sought execution—steps necessarily *following* default.[86] This understanding prevailed unquestioned into the twentieth century.[87] So settled was the rule that the drafters of the Uniform Fraudulent Conveyance Act, published in 1918, saw no need even to address choice of law.[88] The advantage a corporate creditor could gain by movement was therefore slight.

Legal uniformity was further secured by procedural law, in particular the central role federal courts occupied in reorganization proceedings. The railroad receiverships were the first step.[89]

Britain and the United States, 1600-1914: Overcoming Asymmetric Information, 62 BUS. HIST. REV. 199, 209 (1988).

84. Baskin, *supra* note 83, at 216; Tufano, *supra* note 80, at 7 ("Prior to the 1850s, common stock had provided much and sometimes all of the railroad capitalization in the United States. Bonds had been issued only with reluctance . . . .").

85. Lance Edwin Davis, *Stock Ownership in the Early New England Textile Industry*, 32 BUS. HIST. REV. 204, 214-15 (1958).

86. So declared Chancellor Kent as early as 1816. *See* Wiggins v. Armstrong, 2 Johns. Ch. 144, 145 (N.Y. Ch. 1816) ("[U]pon examination of the cases, I am satisfied that a creditor at large, and before judgment and execution, cannot be entitled to the interference which has been granted in this case.").

87. *See, e.g.*, Pusey & Jones Co. v. Hanssen, 261 U.S. 491, 497 (1923) (stating that a contract creditor "has, in the absence of statute, no substantive right, legal or equitable, in or to the property of his debtor," only the right "to have his debt paid in due course"); Garrard Glenn, *The Basis of the Federal Receivership*, 25 COLUM. L. REV. 434, 438 (1925).

88. UNIF. FRAUDULENT CONVEYANCE ACT (UNIF. LAW COMM'N 1918). Even the Uniform Fraudulent Transfer Act, published in 1984 with an eye to replacing the UFCA, had no occasion to consider choice of law. *Cf.* UNIF. VOIDABLE TRANSACTIONS ACT 5 (UNIF. LAW COMM'N 2014) (noting the novelty of choice-of-law rules as one consequence of the 2014 amendments).

89. For useful overviews of the receivership mechanism, see DAVID A. SKEEL JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 56-60 (2001); Douglas G.

Background legal rules effectively handed a railroad's managers, rather than its creditors, the ability to choose the time and place of proceedings. If an unfriendly creditor were to file a bill before the debtor corporation actually defaulted, management could have it dismissed simply by denying the fact of default and pointing to the creditor's adequate remedy at law. In the meantime, however, management could establish federal jurisdiction by finding a friendly creditor of diverse citizenship. This creditor would file a bill alleging default—even if the default was only fictional—and seeking the appointment of a receiver. Now the corporation could admit default, obviating the need for a jury and grounding the equity court's discretion to appoint a receiver.[90] The resulting forum-selection rule was thus baldly asymmetric. When a railroad became insolvent such that its bondholders' control and withdrawal rights were in play, management, but not individual bondholders, could pick the forum, which was inevitably a federal court. Section 34 of the Judiciary Act directed federal courts to apply forum state law,[91] but its charge covered legislative rules only.[92] And because it was management who chose the place and time of reorganization, opportunistic creditors would have been unable to invoke extravagant, privately favorable law. Over time, the logic of reorganization was extended to corporations other than railroads. Nationalization was effectively complete when the bankruptcy statutes of the 1930s channeled, regulated, and expanded voluntary access to the reorganization process.[93]

Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393, 397-408; Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1440-52 (2004). The first known railroad receivership took place in a Georgia state court in 1846. *See* Glenn, *supra* note 87, at 441; *see also* Macon & W. R.R. Co. v. Parker, 9 Ga. 377 (1851) (vindicating first contested use of receivership to reorganize railroad capital structure). Quickly, though, the federal courts became the fora of choice for reorganizing the important railroads.

90. *See* Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 379-82 (1893). Inferior federal courts had approved the use of fictional, dare I say collusive, creditor's bills long before the Supreme Court did. *See, e.g.*, Brassey v. N.Y. & N.E. R.R. Co., 19 F. 663, 668-70 (D. Conn. 1884).

91. Judiciary Act of 1789, 1 Stat. 73, 92.

92. Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842), *abrogated by* Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).

93. *See* Act of June 7, 1934, Pub. L. 73-296, § 77B, 48 Stat. 911, 912 (codifying terms of nonrailroad corporate reorganization); Act of March 3, 1933, Pub. L. No. 72-240, § 77, 47 Stat. 1467, 1474 (codifying terms of railroad reorganization); *see also* Chandler Act, Pub. L. No. 75-696, 52 Stat. 840 (1938) (replacing the 1934 Act).

2. Employees

With respect to constituents other than financial creditors, it is easier to see why inconsistent rules are tolerable. The traditional employment relationship supplies a good illustration. Employment is a broad category, but for now think of a line employee in a manufacturing firm. Relatively little specific investment is required of either the employer or employee. General skills may be important, but firm-specific knowhow less so. At-will contracts prevail. These conditions imply that such employees will be unable to hold up the firm because a long-term arrangement founded on specific investment is a prerequisite to opportunism.[94] Even in cases with a more durable relationship, the fact that most work is tied to a physical location undermines employees' potential holdup threat. Consider, for example, an employee who is paid the minimum wage in *State A* and sees that the minimum wage in neighboring *State B* is higher. To take advantage of *B*'s law, he must relocate, but the act of relocating would at the same time entail relinquishing employment altogether. Whether because the arrangement is at-will or because work is geographically rooted, most employees are poorly positioned to exploit variations in territorial law. Consequently, the variations themselves do not undermine corporate organization.

3. Material and Service Suppliers

Unlike most employees, contractual counterparties for the supply of specialized goods or services may have holdup power. Not for nothing, the long-term supply contract is the paradigmatic site for discussion of the make-or-buy tradeoff.[95] In the modal case, the supplier's cost of mobility is likely to be much higher than the employee's, however. Like an employee, a contract supplier is typically rooted geographically as long as he wishes to continue the arrangement. If a physical plant or other fixed assets are part of the supplier's production process, they exacerbate the cost of opportunistic movement.

94. WILLIAMSON, *supra* note 72, at 26-30; Klein et al., *supra* note 72, at 298.

95. The acquisition of Fisher Body by General Motors is the canonical example. *See* Klein et al., *supra* note 72. *But see* Ramon Casadesus-Masanell & Daniel F. Spulber, *The Fable of Fisher Body*, 43 J.L. & ECON. 67 (2000) (arguing that factors other than holdup prompted the acquisition); R.H. Coase, *The Acquisition of Fisher Body by General Motors*, 43 J.L. & ECON. 15 (2000) (arguing that the facts of the GM-Fisher Body relationship were misunderstood).

4. Involuntary Investors

Tort victims and tax collectors can be understood as involuntary constituents of corporate enterprise. They are, however, constituents with little chance to move opportunistically. Almost by definition, involuntary investors cannot identify themselves until after a corporate wrong. They cannot act opportunistically until after their claims mature. Suppose a person is hit by a truck. He has a plausible but uncertain claim that a corporate actor is at fault—or else he can establish liability with confidence but damages only speculatively. Will our victim move domicile to a new state so he can prosecute the claim under more favorable law? The cost of mobility is high. But if the difference in expected damages were high enough, perhaps he would want to. Here, though, background legal rules further complicate the prospects of opportunism. Under the old rule of *lex loci delicti*, the moment of injury established the law.[96] Even under modern interest-balancing, the location of injury remains an important factor.[97] In expectation, the involuntary investor has little to gain by moving.

IV. THE DOCTRINE'S ORIGINS

On my account, the contours of the internal affairs doctrine are historically contingent. The doctrine reflects the fact that, for a combination of technological and institutional reasons, stockholders are uniquely capable among corporate constituents of moving opportunistically. But stockholders have not always been able to do so. The prospect of opportunistic movement came into focus at a particular time. Consequently, the plausibility of my account as an explanation—and not only a justification—of the internal affairs doctrine depends on the doctrine and the prospect of opportunism developed together in time. This Part aims to show that they are, in fact, harmonious—that the courts developed the internal affairs doctrine in the years shortly after stockholder opportunistic movement became a theoretically important prospect for the first time.[98]

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96. *See, e.g.*, W. Union Tel. Co. v. Brown, 234 U.S. 542, 547 (1914) ("[I]t is established as the law of this court that when a person recovers in one jurisdiction for a tort committed in another he does so on the ground of an obligation incurred at the place of the tort that accompanies the person of the defendant elsewhere, and that is not only the ground but the measure of the maximum recovery.").

97. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145 (AM. LAW INST. 1971).

98. To be clear, I do not claim that the timing *proves* anything about the doctrine's causal origins. One cannot infer a causal link from the relationship of two phenomena in time, and to my knowledge there is no written evidence that the judges who developed the doctrine

The brute facts of the internal affairs doctrine's development are straightforward. Courts first articulated the rule in the 1860s, and it quickly took hold of the lawyerly imagination. Indeed, it took hold so thoroughly that, by 1885, a New Jersey judge was able to describe the doctrine as "almost too obvious for remark."[99] But to connect the doctrine with the advent of the prospect of stockholder opportunism, one must attend more carefully to the legal and economic context in which the doctrine emerged. To that end, this Part sketches two developments during the first half of the nineteenth century that, in combination, gave rise to the possibility of stockholder opportunism: the nationalization of the economy and the liberalization of the law of personal jurisdiction. For reasons to become clear, these processes culminated with the Supreme Court's 1855 decision in *Lafayette Insurance Co. v. French*,[100] after which stockholder opportunistic movement became a theoretically important prospect for the first time.

A. Jurisdiction over Foreign Corporations in Doubt

A doctrine of internal affairs has meaning only in a world where multiple sovereigns are potential sources of law for, or adjudicators of, conflicts involving the corporation. From the Constitution's ratification through the first decades of the 1800s, however, the Republic's federal structure posed little problem for corporate theory. This was so not because the corporation's place in the economy had been conclusively resolved, but rather because the peculiar institution of the corporation mattered to it so little.[101] Few occasions arose in which a sovereign other than the chartering state could even plausibly be invoked as a source of authority in disputes over corporate resources. Little corporate business took place across state lines. At the same time, prevailing understandings of jurisdiction meant that when an interstate dispute involving a corporation did arise, the courts of the chartering state were usually the only available fora.

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were subjectively motivated to respond to opportunistic movement. Nevertheless, the history is important to the account's *plausibility*, and readers who believe judges are apt to decide cases for reasons not reflected in their writing may find the timing more or less telling.

99. Gregory v. N.Y., Lake Erie & W. R.R. Co., 40 N.J. Eq. 38, 44 (Ch. 1885).

100. 59 U.S. (18 How.) 404 (1855).

101. Richard M. Buxbaum, *The Origins of the American "Internal Affairs" Rule in the Corporate Conflict of Laws*, *in* FESTSCHRIFT FÜR GERHARD KEGEL 75, 84 (Hans-Joachim Musielak & Klaus Schurig eds., 1987) ("Until out of state shareholders became common there would have been little occasion for a choice of law inquiry.").

The place of the corporation in the early United States is too well documented elsewhere to merit anything but a brief rehearsal here.[102] Corporations were few in number, and their practical significance, "even for their time, was but slight and local."[103] In the popular imagination, they were conceived as arms of the state. Towns, cities, and counties composed a large share of the early corporations. Indeed, most books written before the 1830s treated business corporations "as only a small and unimportant branch of the law of municipal corporations."[104] Most early, nonmunicipal corporations were chartered to build public infrastructure, especially canals and turnpikes.[105] Entrepreneurs mainly did business without legal form—that is, by proprietorship or partnership.[106] Banks and insurance companies were exceptional in this respect.[107]

Not surprisingly, the activities of early American corporations entailed relatively few direct effects outside the chartering state. Municipalities, tethered as they are to metes and bounds, were naturally centered on local transactions and relations. So, too, were the incorporated religious and philanthropic societies. The corporations that approximated modern business firms—including in some respects the canal and turnpike companies, but also the banks and insurers—tended to operate domestically. Directors and officers were frequently required to reside in the chartering state. Assets as well as capital

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102. The literature on this topic cannot be cited comprehensively. The most thorough study of early American corporations is still 2 JOSEPH STANCLIFFE DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS (1917). For a synoptic take on the early-nineteenth century corporations, see JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 13-57 (1970).

103. DAVIS, *supra* note 102, at 5; *see also* Tung, *supra* note 4, at 46-47 (describing the family run, local nature of businesses before the Industrial Revolution as well as the pre-industrial origins of the doctrine).

104. William F. Cahill, *Jurisdiction over Foreign Corporations and Individuals Who Carry on Business Within the Territory*, 30 HARV. L. REV. 676, 687 (1917).

105. *See, e.g.*, HURST, *supra* note 102, at 17-18 (noting, for example, that of 317 corporations specially chartered between 1780 and 1801, two-thirds were enterprises concerned with travel); Ronald E. Seavoy, *The Public Service Origins of the American Business Corporation*, 52 BUS. HIST. REV. 30, 45-54 (1978).

106. The statutory limited partnership debuted in 1822. For a study of its impact, see Eric Hilt & Katharine O'Banion, *The Limited Partnership in New York, 1822-1858: Partnerships Without Kinship*, 69 J. ECON. HIST. 615 (2009).

107. For example, sixty-three of the sixty-seven companies whose shares were traded on the New York Stock Exchange in 1825 were in banking or insurance. *See* Eric Hilt, *History of American Corporate Governance: Law, Institutions, and Politics*, 6 ANN. REV. FIN. ECON. 1, 4 (2014); *see also* GEORGE HEBERTON EVANS JR., BUSINESS INCORPORATIONS IN THE UNITED STATES, 1800-1943, at 17 (1948) (noting that twenty-four of the sixty-six business incorporations in 1825 in New York were in the finance industry).

providers tended to be local, too. A study of the Massachusetts textile companies, for example, reveals not a single foreign stockholder before 1839.[108]

Given the essentially local character of most early corporations, interstate disputes were understandably rare. When cross-border litigation did occur, prevailing jurisdictional norms channeled most cases into the chartering-state's courts. In the early 1800s, it was open to debate whether corporations were even capable of litigating abroad.[109] American courts unanimously held that corporations could appear in foreign courts if they did so voluntarily, as plaintiffs.[110] But this did not mean a corporation could be *required* to appear in another state as a defendant. To the contrary, settled understandings made it exceedingly difficult for any plaintiff to get relief against a corporation outside the chartering-state's courts.

At common law, jurisdiction of a corporate body was established only by service of a summons "on the mayor or other chief officer."[111] Two premises of the law combined so that compulsion of a foreign corporation was impossible. First, the judicial process was understood

108. Davis, *supra* note 85, at 214-15; *see also* Peter L. Rousseau & Richard Sylla, *Emerging Financial Markets and Early US Growth*, 42 EXPLORATIONS ECON. HIST. 1, 6-9 (2005) (documenting immature secondary markets). When corporate agents sought to make deals interstate, it was not usually to secure capital. *See* Buxbaum, *supra* note 101, at 85, 87. Because capital was mainly sourced locally, cross-border litigation tended to involve the corporation's contract and tort relations. *Id.* at 84.

109. Earnest litigants contended they could not appear abroad even voluntarily. *See* Lucas v. Bank of Ga., 2 Stew. 147 (Ala. 1829); N.Y. Fireman Ins. Co. v. Ely & Parsons, 5 Conn. 560 (1825); Williamson v. Smoot, 7 Mart. (o.s.) 31 (La. 1819); Portsmouth Livery Co. v. Watson, 10 Mass. (10 Tyng) 91 (1813); Silver Lake Bank v. North, 4 Johns. Ch. 370 (N.Y. Ch. 1820); Bank of Marietta v. Pindall, 23 Va. (2 Rand.) 465 (1824).

110. Stewart Kyd's treatise, which by the beginning of the nineteenth century was already known in the United States, cited approvingly a case from the King's Bench in which a Dutch corporation was allowed to appear as plaintiff. 1 STEWART KYD, A TREATISE ON THE LAW OF CORPORATIONS 292 (Garland Publ'g, Inc. 1978) (1973) (citing Henriques v. Gen. Privileged Dutch Co. Trading to the W. Indies, (1728) 92 Eng. Rep. 494; 2 Ld. Raym. 1532 (Eng.)). American courts accepted Kyd's view. *See Portsmouth Livery Co.*, 10 Mass. (10 Tyng) at 91 (rejecting the plea that a Rhode Island-chartered corporation was incapable of bringing trover in Massachusetts court); *see, e.g.*, *Lucas*, 2 Stew. at 147; *N.Y. Fireman Ins. Co.*, 5 Conn. at 560; *Williamson*, 7 Mart. (o.s.) at 31; *Silver Lake Bank*, 4 Johns. Ch. at 372-73 (Kent, Ch.) (foreign corporations may sue in equity as well as law courts); *Bank of Marietta*, 23 Va. (2 Rand.) at 473 ("[T]he point seems to us so clear, on principle, as not to need the support of authority . . . .").

111. 1 KYD, *supra* note 110, at 272; *see* JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 336-40 (Boston, Hillard, Gray, Little & Wilkins 1832).

to have legal effect only within the issuing court's territorial sphere.[112] A foreign corporation's chief officer was not apt to be found there, making service practically difficult to effect. Second, and critically, an executive's official character was understood to end at the border of the state from which his office sprang. He became a mere citizen upon leaving the chartering state and so was not legally capable of receiving service on the corporation's behalf except "within the jurisdiction of the sovereignty where this artificial body [the corporation] exists."[113] One court explained the logic this way: "If the president of a bank of another state, were to come within this state, he would not represent the corporation here; his functions and his character would not accompany him, when he moved beyond the jurisdiction of the government under whose laws he derived this character . . . ."[114] Because courts outside the chartering state could not compel a corporation's appearance, nearly all of the little interstate litigation involving early business corporations took place in the chartering-state's courts—and this was true whether the litigation sounded in contract, tort, or otherwise.[115]

B. Jurisdiction over Foreign Corporations Established

As the railroad age dawned, the business corporation assumed an increasingly important place in an increasingly national economy. Developing transportation and communication networks allowed entrepreneurs more cheaply to exploit capital, labor, supply, and

112. *See* Kibbe v. Kibbe, 1 Kirby 119 (Conn. Super. Ct. 1786) (holding service made in Connecticut ineffective to vest Massachusetts court with jurisdiction over defendant); Kilburn v. Woodworth, 5 Johns. 37 (N.Y. Sup. Ct. 1809) (holding service of a Massachusetts process to a New York resident, in New York territory, impossible) .

113. Peckham v. Inhabitants of the N. Parish in Haverhill, 33 Mass. (16 Pick.) 274, 286 (1834); *In re* M'Queen v. Middletown Mfg. Co., 16 Johns. 5, 7 (N.Y. Sup. Ct. 1819).

114. *In re M'Queen*, 16 Johns. at 7; *accord* Middlebrooks v. Springfield Fire Ins. Co., 14 Conn. 301, 306 (1841); *Peckham*, 33 Mass. (16 Pick.) at 286; *cf.* Bushel v. Commonwealth Ins. Co., 15 Serg. & Rawle 173, 176 (Pa. 1827) (leaving open the possibility that a foreign corporation's president could be served abroad if he was then conducting business on the corporation's behalf).

115. The writ of foreign attachment provided one method by which plaintiffs could induce a foreign corporation to litigate outside its chartering state. If a plaintiff could find local assets of sufficient size relative to the judgment he sought, the foreign corporation might decide to appear voluntarily, at which point the court's personal jurisdiction would be established. But foreign attachment was not especially effective in most cases. Not all courts accepted it as a proper remedy. *Compare, e.g.*, *Peckham*, 33 Mass. (16 Pick.) at 282 (attachment improper), *and M'Queen*, 16 Johns. at 5 (same), *with* St. Louis Perpetual Ins. Co. v. Cohen, 9 Mo. 421, 446 (1845) (attachment proper), *and Bushel*, 15 Serg. & Rawle at 176 (same). Moreover, attachment was practical only if the plaintiff could find enough locally situated assets, a condition that would be satisfied only occasionally.

customer markets across state lines. Access to wider markets also increased demand for corporate charters because the corporate form facilitated the capital accumulation needed for scale. State legislatures responded by granting many more charters, in some cases even authorizing general incorporation—if limited by industry and other factors.[116] The number of corporations grew rapidly along with their geographic reach.[117]

A greater amount of interstate, corporate litigation was inevitable. If the jurisdictional doctrines of the early Republic had persisted, most of this litigation would have been confined to chartering-state courts. But legislatures also responded to changing circumstances along this margin. They began to relax the common-law rule of service, authorizing plaintiffs to serve summonses on corporate agents other than the chief executive.[118] The idea was to enable *in personam* judgments against foreign corporations. Florida enacted the first statute of this kind in 1829.[119] Maryland followed suit in 1834,[120] and others were to do the same. The trend, if it can be called that, reflected to some extent a sense of manifest fairness, of tit-for-tat. If a foreign corporation could use the state's courts to its ends against local residents, why should residents not likewise find a local remedy against the foreign corporation?[121] The laws were not only about settling

116. *See* Richard Sylla & Robert E. Wright, *Corporation Formation in the Antebellum United States in Comparative Context*, 55 BUS. HIST. 653, 657 (2013) (documenting growth in a number of special charters); Eric Hilt, *Corporation Law and the Shift Toward Open Access in the Antebellum United States* 32 (Nat'l Bureau of Econ. Research, Working Paper No. 21195, 2015), https://www.nber.org/papers/w21195.pdf (showing that twenty-three states enacted a general incorporation law in the twenty years after 1836).

117. By one count, state legislatures granted 2551 special charters in the thirty years from 1790-1819, and 18,291 in the thirty years from 1830-1859. Sylla & Wright, *supra* note 116, at 657.

118. *See* St. Clair v. Cox, 106 U.S. 350, 355 (1882) (ascribing the change to the fact that "[t]he great increase in the number of corporations of late years, and the immense extent of their business, only made this inconvenience and injustice more frequent and marked").

119. *See* GERARD CARL HENDERSON, THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW 80 (1918) (citing 1829 Fla. Laws 144).

120. *See* Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519, 592 (1839) (describing statute prescribing "the manner in which corporations not chartered by the state, 'which shall transact or shall have transacted business' in the state, may be sued in its Courts upon contracts made in the state" (quoting Ch. No. 89, 1834 Md. Laws 102)).

121. *See, e.g.*, St. Louis Perpetual Ins. Co. v. Cohen, 9 Mo. 421, 446 (1845) ("[W]here is the reciprocity in permitting foreign corporations to sue in our courts, and holding that they in turn cannot be sued in them, in the only mode in which they can be made liable out of the jurisdiction in which they are created?"); Clarke v. N.J. Steam Nav. Co., 5 F. Cas. 974, 977 (C.C.R.I. 1841) (No. 2859) ("If a foreign corporation may sue, it may also be sued in another

scores, though. To the contrary, foreign companies were apt to find more eager business partners, on more generous terms, if they could credibly commit to having disputes resolved in a geographically proximate and hence low-cost tribunal.

Most states continued to adhere to the traditional service rule, however.[122] Stephen Sachs has recently shown that statutes conferring extraordinary jurisdiction faced an uneven reception before the Fourteenth Amendment's ratification in 1868.[123] Grants of unusually broad jurisdiction were valid within the enacting state's territory, in the sense that the state's own courts and agencies were bound to honor judgments issued under them. If a prevailing plaintiff could find local assets on which to execute, he was in business. But such judgments were void elsewhere. Officials in other states were obliged to give full faith and credit only to judgments issued under jurisdictional grants consistent with prevailing norms of customary international law.[124] If, then, as would often prove the case, the foreign corporation's local assets were insufficient to satisfy a prospective judgment, the plaintiff was out of luck. Thus, the states' unilateral attempts to expand jurisdiction over foreign corporations were of limited significance.

Then, in 1855, everything changed when the Supreme Court decided *Lafayette Insurance Co. v. French*.[125] The case turned on just this question—whether a judgment founded on service to a mere agent of a foreign corporation deserved full faith and credit.[126] The case's facts are suggestive of the growing interstate character of many corporate activities. Lafayette, an Indiana corporation, issued fire insurance policies in Cincinnati. Ohio had on its books a law providing that, with respect to foreign insurers, the service of a summons on any agent found locally was to be "effectual as though the same were served on the principal."[127] In other words, Ohio courts were to assert personal

jurisdiction, at least to the extent of subjecting its property, found within the jurisdiction, to the process and decree of the courts thereof . . . .").

122. An 1838 decision out of New Hampshire, whose law allowed liberal service, flatly acknowledged that the state's policy was in the minority. *See* Libbey v. Hogdon, 9 N.H. 394, 397-98 (1838).

123. Stephen E. Sachs, Pennoyer *Was Right*, 95 TEX. L. REV. 1249, 1269-87 (2017).

124. The law of recognition of foreign judgments was a matter of general law. *See id.* at 1273. But *Mills v. Duryee* held that the Full Faith and Credit Clause and its implementing statute superseded the general law to the extent of inconsistency. 11 U.S. (7 Cranch) 481 (1813); *see* U.S. CONST. art. IV, § 1; Act of May 26, 1790, ch. 11, 1 Stat. 122.

125. 59 U.S. (18 How.) 404 (1855).

126. *See* U.S. CONST. art. IV, § 1.

127. *Lafayette Ins.*, 59 U.S. (18 How.) at 406.

jurisdiction over a foreign insurer if any of its agents was served in the state. Consistent with the statute, the plaintiff insureds, Ohio residents, served a summons in Cincinnati and won a judgment in Ohio court.[128] They then sued on the judgment in federal court in Indiana—presumably because the company had no assets in Ohio, or at least none the plaintiffs could find.[129] The question presented by the case was what preclusive effect, if any, the Ohio judgment was to have outside the state. Lafayette contended plausibly enough that the judgment was void for lack of jurisdiction. But the Court's judgment was for the insureds. A judgment founded on service to a mere agent of the corporation was entitled to full faith and credit.[130]

With this, the jurisdictional hurdle was surmounted. It was now clear the states could, if they wished, subject any foreign corporation doing business locally to the authority of its domestic courts. Legislatures took the cue. In the years that followed *Lafayette Insurance*, every state enacted a so-called "foreign corporation" law.[131] These laws conferred a broad jurisdiction over claims involving activity in the host state. For example, Indiana's provided jurisdiction in any action "arising out of any transaction in this State with [the corporation's] agents."[132] Maryland assured its courts a similarly wide sweep: "[A]ny corporation not chartered by the laws of this State, which shall transact business therein, shall be deemed to hold and exercise franchises within this State, and shall be liable to suit in any of the courts of this State, on any dealings or transactions therein."[133] Besides granting liberal jurisdiction, the foreign corporation laws made the jurisdiction easy to invoke. Almost all of the new laws required foreign corporations to appoint a local agent to receive process.[134]

128. *Id.* Lafayette probably defaulted, although the case report does not say. Had the company appeared to contest the merits, the Ohio court's jurisdiction could have been perfected.

129. *Id.*

130. *Id.*

131. For a general account of these acts, see William Laurens Walker, *Foreign Corporation Laws: The Loss of Reason*, 47 N.C. L. REV. 1 (1968). Walker dates the first act conditioning recognition of foreign corporations *generally* to 1852, in Indiana. *Id.* at 11. Before then, some states had laws purporting to confer jurisdiction over certain categories of foreign corporation only. The Ohio statute at issue in *Lafayette Insurance*, which was limited to insurance companies, is one example. But primarily, states enacted foreign corporation laws after 1855. *Id.* at 13-17.

132. Ch. No. 25 § 2, 1852 Ind. Acts 242, 243.

133. Ch. No. 471 § 209, 1868 Md. Laws 911, 970.

134. Walker, *supra* note 131, at 13-14.

Bringing a foreign corporation to court would henceforth be an administrative exercise.

After 1855, then, the basic doubt about a state's power to assert personal jurisdiction over foreign corporations was resolved.[135] Plaintiffs residing outside a corporation's chartering state could now win judgment locally and, if satisfaction was not forthcoming, sue on the judgment wherever corporate assets might be found. The courts were now open to claims made against, as well as by, foreign corporations.

C. *Internal and External Affairs Differentiated*

It was in this world—where personal jurisdiction of foreign corporations was assured and where the scale of interstate corporate activity was greater than it ever had been—that the internal affairs doctrine first emerged. Contract and tort cases involving foreign corporations quickly became staples of the judicial diet. Yet the courts continued to disclaim jurisdiction of many cases involving the rights and obligations of foreign corporation stockholders, directors, and officers, relative to one another. Personal jurisdiction having been established, this abstention required a new explanation. Now the courts began to invoke the language of subject-matter jurisdiction, insisting they lacked authority to entertain cases brought by stockholders against foreign corporations.[136]

Disputes over dividend policy furnished much of the raw material from which courts constructed the internal affairs doctrine. Even

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135. R.R. Co. v. Koontz, 104 U.S. 5, 10 (1881) (describing the liability to suit of a corporation in the courts of states in which it does business as "well settled").

136. *See, e.g.*, Pierce v. Equitable Life Assur. Soc. of U.S., 12 N.E. 858, 864 (Mass. 1887) ("The subject-matter would not be within our province."); Kan. & E. R.R. Constr. Co. v. Topeka, Salina & W. R.R. Co., 135 Mass. 34, 40 (1883) ("Because this railroad corporation has appeared here by attorney, it has not given this court any right to exercise authority over its organization, its corporate functions, or the relations between the corporation and its members, nor the right to determine who shall be its members . . . ."); Smith v. Mut. Life Ins. Co. of N.Y., 96 Mass. (14 Allen) 336, 341 (1867) ("He may still plead a want of jurisdiction on the ground that the subject matter of the suit, or the remedy sought, is beyond the reach of the court, or not within the sovereign power of the state from which the court has its authority."); Sauerbrunn v. Hartford Life Ins. Co., 115 N.E. 1001, 1004 (N.Y. 1917) ("True the defendant appeared in the action, and the court had jurisdiction of the person, but such jurisdiction did not of necessity extend to jurisdiction of the subject-matter."); Berford v. N.Y. Iron Mine, 4 N.Y.S. 836, 837 (N.Y. Sup. Ct. 1888) (holding that the court lacks "jurisdiction of the subject of the action" where a plaintiff seeks "interfer[ence] with the internal administration of the affairs of a foreign corporation"); Taylor v. Mut. Reserve Fund Life Ass'n of N.Y., 33 S.E. 385, 388 (Va. 1899) ("[T]he internal management of a foreign corporation [is] a subject-matter over which the court has no jurisdiction.").

before the internal-external cleavage was so called, courts outside the chartering state routinely disclaimed any authority to resolve dividend cases. Typical of the genre is an 1866 case out of Massachusetts, *Williston v. Michigan Southern & Northern Indiana Railroad Co.*[137] The plaintiff, a Massachusetts resident, held guaranteed stock, a kind of preferred stock, in the defendant, a foreign-incorporated railroad. This stock entitled the holder to stated, semi-annual dividends in addition to the right to share in dividends made to common stockholders. The plaintiff sued on an unpaid dividend in Massachusetts court. He brought his suit at law, on the theory that the stock provided him with a debt claim,[138] but the court rejected the theory of the case on the ground that preferred stockholders are not creditors.[139] In the alternative, Williston suggested that his suit be converted to a bill in equity and that a decree be issued ordering payment of the contested dividend. But this, too, the court declined to do. In principle a conversion would be appropriate, the court opined, "[b]ut the defendants are a foreign corporation, having no place of business or officers in this commonwealth."[140] The court had personal jurisdiction of the corporation but would not entertain the subject matter of the particular claim. The plaintiff's remedy, if he was to have any, was reserved for "courts having general jurisdiction over the corporation."[141]

Williston reflected the idea of "internal affairs," but the phrase appeared in this context for the first time in another dividend case decided two years later.[142] At issue in *Howell v. Chicago & North Western Railway Co.* was the propriety of an injunction *against* the declaration of a dividend by a foreign corporation.[143] The plaintiff was a preferred stockholder in the company. Its directors, at least some of whom resided in New York, declared a stock dividend, rather than the cash dividend Howell wanted. Unhappy about the decision, Howell asked a New York court to block the directors' plan. The court rejected his submission out of hand. Although he saw nothing objectionable in

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137. 95 Mass. (13 Allen) 400 (1866).

138. *Cf.* William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1819-20 (2013) (explaining that preferred stock presents an enduring characterization puzzle because it has debt-like and equity-like attributes).

139. *Williston*, 95 Mass. (13 Allen) at 404-05.

140. *Id.* at 406.

141. *Id.*

142. A search of the Westlaw database turns up the report of one antebellum case in which the phrase is used—by counsel. *See* Tuttle v. Walton, 1 Ga. 43 (1846).

143. 51 Barb. 378 (N.Y. Sup. Ct. 1868).

the company's declared policy, the judge declined to reach the merits because, in his view, it would be inappropriate to opine on a stockholder's rights against a foreign corporation.[144] In so saying, *Howell* for the first time distinguished clearly between a foreign corporation's "external" relations, which New York courts would police in appropriate cases, and its "internal" activities, which they would not:

> It is the duty of the state to provide for the collection of debts from foreign corporations, due to its citizens, and this has been done; and it is the duty of the state to protect its citizens from fraud, by all the means in its power, whether against domestic or foreign wrongdoers. This, however, does not authorize the courts to regulate the internal affairs of foreign corporations.[145]

Dividend policy was the paradigmatic case of internal affairs.[146] Member contribution cases, concerning investors' obligation to commit additional equity capital to the company, were also common.[147]

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144. *Id.* at 380-82.

145. *Id.* at 383.

146. *See, e.g.*, Gregory v. N.Y., Lake Erie & W. R.R. Co., 40 N.J. Eq. 38 (Ch. 1885); Berford v. N.Y. Iron Mine, 4 N.Y.S. 836, 837-38 (N.Y. Sup. Ct. 1888); Redmond v. Enfield Mfg. Co., 13 Abb. Pr. (n.s.) 332, 333 (N.Y. Sup. Ct. 1872) (asserting authority to order division of foreign corporation's assets for benefit of creditors but not stockholders). As the internal affairs doctrine developed, its contours were not always clear, but dividend policy was understood to be central. *See* Guilford v. W. Union Tel. Co., 61 N.W. 324 (Minn. 1894) (explaining that the line between a corporation's internal and external affairs is not always clear, but that suits "to restrain [the corporation] from declaring a dividend, or to compel it to make one," are a clear case).

147. *Smith v. Mutual Life Insurance Co. of New York* is exemplary. 96 Mass. (14 Allen), 336, 336 (1867); *see also* Taylor v. Mut. Reserve Fund Life Ass'n of N.Y., 33 S.E. 385, 386-88 (holding that, despite proper service, Virginia courts lack jurisdiction over suit by member of New York mutual to block assessment). Most of the early internal affairs cases sound in "adjudicatory" jurisdiction. The "legislative" jurisdiction component of the doctrine was rarely cited but was always present. It was rarely cited because a court that dismisses a case on jurisdictional grounds has no reason to opine on choice of law. But the courts were always willing to decide cases *against* a foreign corporation's local stockholder—that is, cases asserting that a local resident owed a debt by virtue of his stock in a foreign corporation. Some such suits were brought by the foreign corporation's creditors, who alleged the stockholder's derivative liability upon an unsatisfied execution. *See, e.g.*, Halsey v. McLean, 94 Mass. (12 Allen) 438, 441-44 (1866); Erickson v. Nesmith, 86 Mass. (4 Allen) 233, 237 (1862); Erickson v. Nesmith, 81 Mass. (15 Gray.) 221 (1860); Merrick v. Van Santvoord, 34 N.Y. 208 (1866). Others were brought by the corporation itself, usually to enforce a capital call on subscribed stock. *See, e.g.*, Morris v. Glenn, 7 So. 90 (Ala. 1888); Mandel v. Swan Land & Cattle Co., 40 N.E. 462 (Ill. 1895); Merrimac Mining Co. v. Levy, 54 Pa. 227 (1867). In these cases, chartering-state law was uniformly applied. *See Morris*, 7 So. at 90-91; *Mandel*, 40 N.E. at 463; *Halsey*, 94 Mass. (12 Allen) at 440 (holding that New York law applied because the plaintiff's contract must have been "in legal contemplation made with reference to the New York acts"); *Erickson*, 81 Mass. (15 Gray.) at 222 ("The liability on which the present action

Formally, a contribution claim is the inverse of a dividend claim. But both concern the balance of assets to be held in corporate solution and are in that sense about capital formation. By the 1880s, what began as a loose norm, or metaphor, had crystalized as doctrine.[148] Claims brought by or against stockholders were limited to the law, and usually the courts, of the chartering state; claims brought by or against other corporate constituents were not.

V. IMPLICATIONS

What follows from understanding the internal affairs doctrine as a pragmatic resolution to a vexing collective-action problem? This Article outlines two implications that may be less obvious—one about the corporation's purpose and the other about its future.

A. *The Objective Function of the Corporation*

An important implication of my account is the irrelevance of corporate law, narrowly defined, to normative conceptions of the corporation. Consider what is perhaps the longest-standing subject of debate among those who study corporations—the purpose or purposes for which they exist.[149] At the risk of oversimplifying, this debate pits proponents of stockholder-centric theories of corporate purpose, whether aimed at maximizing stockholder wealth or welfare,[150] against those who favor one or another version of multilateral or stakeholder theory.[151]

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is founded is created solely by the statutes of the State of New Hampshire . . . ."); *Merrick*, 34 N.Y. at 208 (holding that Connecticut law applied to an action by a corporation's creditor, brought in New York, against a New York stockholder); *Merrimac Mining*, 54 Pa. at 230.

148. *See Gregory*, 40 N.J. Eq. at 44 (describing the doctrine that a court would not interfere with a foreign corporation's "internal affairs" as "almost too obvious for remark").

149. Depending on how one parses the question, this is the same as, or else only modestly different from, the question of toward what purpose corporate directors should exercise their authority. Scholarly debate on this score dates at least to the famous Berle-Dodd exchange in the early 1930s. *See* A.A. Berle Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); A.A. Berle Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

150. For discussion of these alternatives, see Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247, 247-49 (2017).

151. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 549-50 (2003) (arraying prevailing conceptions of corporate "ends" on stockholder-to-stakeholder axis).

Variations within these "camps" are real and important, but the merits are beside the point here. What is in issue, rather, is the form of argument. In particular, my account suggests that a widely used mode of argument in this debate is deeply flawed and should cease. This is the mode that derives normative principles, or support for such principles, inductively from decisions in corporate law cases. It is commonly found in the writing of sophisticated scholars and in leading casebooks, and it accounts for the prevalence in debates about corporate purpose of such cases as *Dodge v. Ford Motor Co.*,[152] *A.P. Smith Manufacturing Co. v. Barlow*,[153] and *Shlensky v. Wrigley*.[154] Reliance on cases like these is in one sense understandable. They sound grand themes. Here, for example, is an oft-cited quotation from *Dodge*: "There should be no confusion . . . . A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."[155] This *sounds* like authority on the question of corporate purpose.

My account of the internal affairs doctrine shows, however, why it is a mistake to read the cases that way. A chartering-state's law governs only disputes among and between a subset of constituents, namely stockholders, directors, and officers.[156] Corporation statutes and the case law interpreting them can thus do no more than elaborate the rights and obligations these constituents bear with respect to one another. However expansive the judicial language used in a corporate law opinion might be, its context binds its significance. The most a corporate law decision can say on behalf of a stockholder-wealth maximization norm, for example, is that the courts will grant stockholders relief against a board that flouts such a norm. It can say nothing about what creditors or employees or other constituents are entitled to demand from the board. And the same goes for every normative conception of corporate purpose. Cases such as *Dodge*, *Barlow*, and *Shlensky* might illuminate the law of stockholder suits, but they are necessarily incapable of instructing lawyers or entrepreneurs about the purpose or function of the corporation *in general*. An

152. 170 N.W. 668 (Mich. 1919).

153. 98 A.2d 581 (N.J. 1953).

154. 237 N.E.2d 776 (Ill. App. Ct. 1968).

155. 170 N.W. at 684.

156. I am putting to one side the effect chartering-state law can have, in principle, through its definition of *ultra vires* powers. There is also a split of authority concerning the application of chartering-state law to disputes over stockholder liability for corporate debts. These are of marginal significance.

inductive approach to that question requires the investigation of sources of law other than that of the chartering state and the harmonization of corporate law with them.[157]

One need not resort to the account of the internal affairs doctrine offered here to observe that corporate law's domain is bounded. Indeed, others have noticed that one must attend to the interaction of corporate law with other sources of law if one hopes to understand the corporation as an economic phenomenon.[158] But my account emphasizes the essentially contingent character of corporate law's domain. Not only are stockholder-manager relations not the only "corporate" relations, they are not even necessarily the most important, not even first among equals.

B. Dynamic Boundaries?

The corporate boundary wrought by the internal affairs doctrine has proved remarkably robust. Although the "adjudicatory" jurisdiction component of the early doctrine has disappeared,[159] the law's identification of the corporation with its stockholders, directors, and officers has persisted. But the logic of the account offered here is the logic of adaptation. If technological or legal conditions change, such that opportunistic movement by constituents other than stockholders becomes a concern, one might expect the corporation's very definition to change too.[160] A productive way to model the content of corporate law is as one among many inputs to a complex governance system, simultaneously influencing and reacting to the institutional

157. For an example of this approach to the law of director obligation in the so-called "vicinity of insolvency," see Vincent S.J. Buccola, *Beyond Insolvency*, 62 KAN. L. REV. 1 (2013).

158. *See, e.g.*, Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 LAW & CONTEMP. PROBS. 109, 110-11, 119-25 (2004) (documenting "the vibrancy of stakeholder protection and corporate social responsibility outside of 'corporate law'"); *see also id.* at 128-29 (citing additional texts that note the importance of harmonizing corporate with other bodies of law).

159. *See* discussion *supra* Part II.

160. At least, the strength of path dependency associated with settled doctrine would be put to the test. A plausible evolutionary account of legal change has to take prior conditions into account. *See generally* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996) (describing how our decisions today are affected by past decisions). A substitute mechanism to police opportunism, such as a federal choice-of-law rule, might face less resistance.

and technological environment.[161] It might be appropriate to view corporate law's *scope* similarly.

Skilled labor, in particular, seems especially likely to be "brought inside" the corporation. Physical assets were the critical, specific input in most incorporated enterprises in the past.[162] Today, the most important assets in many industries are employees, or, as economists would say, human capital.[163] Meanwhile the cost of labor mobility are steadily decreasing due to improvements in travel and telecommunications technologies. Contracting about specific human capital is notoriously tricky,[164] not least because norms against involuntary servitude prevent the kind of integration one would expect to find where analogous investments in physical capital are noncontractible.[165] Under current law, the employer-employee relationship is outside corporate law's domain. Territorial choice-of-law norms apply, meaning that incentives for opportunistic movement may be at play. An employee who can move cheaply to an "interventionist" state—a jurisdiction that permits employees to "withdraw" human capital liberally—will benefit individually but will also undermine, to some extent, the utility of the firm as a coordination mechanism.

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161. *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 868 (2013); Hilt, *supra* note 107, at 16.

162. *See, e.g.*, Raghuram G. Rajan & Luigi Zingales, *The Governance of the New Enterprise*, *in* CORPORATE GOVERNANCE 201 (Xavier Vives ed. 2000) ("[A]ssets were very hard to replicate and were primarily what made the firm unique. The human capital of employees was, in large part, tied to these assets and immobile.").

163. Rajan & Zingales, *supra* note 162, at 202 ("Recent changes in the nature of organizations, the extent and requirements of markets, and the availability of financing have made specialized human capital much more important, and also much more mobile."); Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 82 (2004) ("In a service-oriented economy, the assets walk out the door at 5:00pm."); Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 187 (2017).

164. For an analysis of the problem and a description of some ameliorating arrangements, see Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 58, 72-79 (Margaret M. Blair & Mark J. Roe eds., 1999). *Cf.* Lynn A. Stout, *On the Nature of Corporations*, 2005 U. ILL. L. REV. 253, 256 n.7 ("To say that firm-specific assets lose their value when withdrawn from the firm does not mean that all such assets can be locked into the firm. Employees can leave firms relatively easily, for example, and when they do the value of their firm specific human capital evaporates.").

165. *See, e.g.*, Grossman & Hart, *supra* note 9.

Consider in this vein the covenant not to compete. The noncompete is a partial substitute for integration and can induce an employer to invest efficiently in its employees' human capital.[166] It partially locks in specific human capital by barring for a period of time its "withdrawal" and reinvestment elsewhere. California courts do not enforce these covenants, however.[167] They will not even enforce a noncompete entered out of state while the employee resided and worked elsewhere.[168] In effect, California offers employees the right to withdraw human capital on terms more favorable than they would enjoy in other states. All else equal, one should expect to see human capital flowing toward California.[169] The dynamic resembles the latent threat of opportunistic stock trading central to my account of internal affairs. Whether the resemblance is close enough to warrant revisiting the doctrine is an open question, but a question nonetheless.

VI. CONCLUSION

Essential facts about the corporation cannot explain the weight placed on the nineteenth-century distinction between internal and external affairs. Something else, some practical end is behind what became the internal affairs rule. My aim has been to make the case for the significance of contingent technological and institutional facts—that differences between the practical situation of equity investment, on one hand, and labor, debt, materials, and so on, on the other, call for a special rule making stockholders' rights and obligations uniform. On this view, a particular form of opportunism accounts for chartering states' continuing monopoly over the stockholder-manager relationship. Although the intervening 150 years have seen many changes in the

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166. *See* Eric A. Posner et al., Investing in Human Capital: The Efficiency of Covenants Not to Compete (Jan. 2004) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=285805.

167. CAL. BUS. & PROF. CODE § 16600 (West 2017).

168. *See* Application Grp., Inc. v. Hunter Grp., Inc., 72 Cal. Rptr. 2d 73 (Ct. App. 1998) (affirming a declaration that a noncompete covenant agreed to in North Carolina could not be enforced against former employee who had since moved to California).

169. A well-known argument traces Silicon Valley's dominance in computer technology to California's policy on noncompetes. *See* Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 609 (1999); Alan Hyde, *Silicon Valley's High-Velocity Labor Market*, 11 J. APPLIED CORP. FIN. 28, 36 (1998). The idea is that the unenforceability of promises not to compete enhances labor mobility and, with mobility, productive cross-pollination. The perspective taken here suggests a more nefarious aspect to California's noncompete policy. The policy might be inducing employees in firms located outside California to withdraw their human capital opportunistically.

entrepreneurial landscape, the margins central to my account have remained more or less stable, and so too has the doctrine of internal affairs. Whether this stability is likely to persist is an open question. But in any case, the account shows why one should not look to the pronouncements of corporate lawyers and chancellors for normative bearings. In a world of interstate enterprise, most of the law of corporate activity—the real *law of the corporation*—rests comfortably beyond corporate law's domain.