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**JURISDICTION AND PROCEDURE**

## The Internal Affairs Doctrine Versus A Conflicting Contractual Choice Of Law Provision



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**A**s companies regularly operate in multiple states, the question arises as to which state's law controls disputes among or between companies and their directors, officers, and shareholders. This question can be particularly complicated when an executive's employment agreement contains an arguably applicable choice of law provision specifying a jurisdiction's law other than that of his or her company's incorporating state.

Consider the following example: an executive of a company incorporated in Delaware, headquartered in California, and doing business in several states, has an employment agreement containing a California choice of law provision. Would Delaware law (under the internal affairs doctrine) or California law (under the presumably applicable contractual choice of law provision) govern a breach of fiduciary duty claim asserted against

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that executive? Below, we explore this question, and provide suggestions about avoiding unintended results when drafting executive employment agreements.

The internal affairs doctrine, a choice of law rule used exclusively in the corporate context, selects the incorporating state's law to govern disputes about a company's governance. Because companies are incorporated in only one state, the internal affairs doctrine is an easily applied, bright-line rule that promotes interstate comity and encourages board service by clarifying at the outset the law governing business decisions that may be questioned later. Also, a neutral mandate like the internal affairs doctrine prevents judges and arbitrators from making subjective choice of law decisions that may be unfairly prejudiced by their forum ties. Most courts thus apply the incorporating state's law to breach of fiduciary duty claims.<sup>1</sup>

But what happens in an internal affairs case when an ostensibly applicable contractual choice of law provision specifies the (conflicting) law of a state other than that of the incorporating state? Only a few courts have

<sup>1</sup> The internal affairs doctrine, however, is not consistently followed throughout the states. California, for instance, enacted a statutory exception to the doctrine. See Cal. Corp. Code § 2115. Under Section 2115, enumerated provisions of California's corporate law govern a company incorporated in another state (i.e., a foreign company) if (1) more than half of the company's voting stock is held by California residents; (2) the company conducts a majority of its business in California (as measured by its assets, payroll, and sales); and (3) the company's shares are not listed or traded on a national exchange. Significantly, unlike other jurisdictions, courts have held that California law does not extend business judgment rule protections to officers. See, e.g., *F.D.I.C. v. Perry*, Case No. CV 11-5561-ODW, 2012 WL 589569, at \*4 (C.D. Cal. Feb. 21, 2012). Accordingly, an officer of a foreign company that conducts most of its business in California may lack legal protections that he or she expected to receive under the incorporating state's law.

considered this issue, and nearly all have applied the incorporating state's law under the internal affairs doctrine.<sup>2</sup> Take the following two examples.

In *Heine v. Streamline Foods Inc.*, the plaintiff brought a breach of fiduciary duty claim regarding dividends authorized by the defendant directors. The plaintiff argued that because the parties' stockholders agreement contained an Ohio choice of law provision, Ohio law controlled the breach of fiduciary duty claim, as opposed to Delaware law under the internal affairs doctrine. After surveying relevant cases, the court rejected the plaintiff's argument, finding that in those authorities, "the internal affairs doctrine applied even when choice-of-law provisions existed and when those agreements presumably addressed issues of corporate governance."

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**Executives of the same company could face inconsistent fiduciary duty standards based on their choice of different jurisdictions' law if executives' fiduciary duty standards were contractually determined.**

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And in *Rosenmiller v. Bordes*, the owners of a Delaware company executed a shareholders agreement containing a voting restriction and a New Jersey choice of law provision. The co-equal owners could not resolve a stockholder deadlock regarding director elections. The defendant argued that New Jersey law, rather than Delaware law under the internal affairs doctrine, controlled the validity of the contractual voting restriction due to the agreement's choice of law provision. The court disagreed, concluding that Delaware has "a greater interest than does New Jersey in regulating stockholder voting rights in Delaware corporations. The parties' express choice of New Jersey law cannot be controlling as to this issue."

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<sup>2</sup> See, e.g., *Matson Logistics, LLC v. Smiens*, Case No. 12-400 ADM/JJK, 2012 BL 137597 WL 2005607 (D. Minn. June 5, 2012) (applying Minnesota law to a veil-piercing claim in a suit involving an Ohio contractual choice of law provision and a Minnesota company); *Heine v. Streamline Foods Inc.*, 805 F. Supp. 2d 383 Case No. 1:10 CV 637, 2011 WL 3296199 (N.D. Ohio July 29, 2011) (applying Delaware law to a breach of fiduciary duty claim in a suit involving an Ohio contractual choice of law provision and a Delaware company); *Rosenmiller v. Bordes*, 607 A.2d 465, 468-69 (Del. Ch. 1991) (applying Delaware law to a claim regarding a shareholder voting restriction in a suit involving a New Jersey contractual choice of law provision and a Delaware company); *In re PHP Healthcare Corp.*, 128 F. App'x 839 (3d Cir. 2005) (unpublished); *Marcus v. Lincolnshire Management Inc.*, 409 F. Supp. 2d 474 (S.D.N.Y. 2006); *Storetrax.com, Inc. v. Gurland*, 915 A.2d 991, 999-1000 (Md. 2007) (affirming application of the incorporating state's law to a breach of fiduciary duty claim over a conflicting choice of law provision); *Patriot Scientific Corp. v. Korodi*, 504 F. Supp. 2d 952, 956-57 (S.D. Cal. 2007); *In re Del-Met Corp.*, 322 B.R. 781, 801 (M.D. Tenn. 2005) (refusing to enforce the parties' stipulated choice of law to breach of fiduciary duty claims because that law "collide[d] with [the] firmly established [internal affairs] doctrine").

At least two courts, however, have found differently.<sup>3</sup>

First, in *Boyle v. Jacor Commc'ns, Inc.*, the Southern District of Ohio applied to a veil piercing claim New York law under a contractual choice of law provision rather than the incorporating state's law. But the court did not even mention the internal affairs doctrine. Indeed, it may have been unaware of the doctrine's potential applicability as it warns in its opinion that "[t]his is a complicated case [and n]either counsel has cited any law in support of their respective positions." The *Boyle* court's upholding of the contractual choice of law provision has been criticized.<sup>4</sup>

Second, in *Johnson v. Myers*, the Northern District of California considered whether to apply British law (under the internal affairs doctrine) or California law (per a contractual choice of law provision) to, among others, a breach of contract claim involving a director's performance. Using California choice of law principles, the *Johnson* court applied California law to the breach of contract claim, despite having found that it implicated the company's internal affairs.

As support, the *Johnson* court cited two cases applying California law that "analyzed the choice-of-law clauses before the internal affairs doctrine," thereby purportedly "indicat[ing] strong presumptions in favor [of] enforcing contractual choice-of-law provisions."<sup>5</sup> But neither of these cases involved a conflict between the internal affairs doctrine and a contractual choice of law provision. In *Nedlloyd Lines*, for example, the court honored the parties' Hong Kong contractual choice of law provision, but the relevant company was incorporated in Hong Kong. The contractual choice of law provision and the internal affairs doctrine therefore required application of the same law.

Also, the *Johnson* court asserted that California "disfavor[s]" the internal affairs doctrine as shown by its codification of Cal. Corp. Code Section 2115 as an exception to that doctrine. But the court did not acknowledge authority that criticizes Section 2115.<sup>6</sup> Nor

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<sup>3</sup> See *Boyle v. Jacor Commc'ns, Inc.*, 799 F. Supp. 811 (S.D. Ohio 1992); *Johnson v. Myers*, Case No. CV-11-00092 JF, 2011 BL 252073 2011 WL 4533198 (N.D. Cal. Sept. 30, 2011).

<sup>4</sup> See *Matson Logistics*, 2012 BL 137597 at \*7 2012 WL 2005607, at \*6 ("[T]his Court is not convinced that [Boyle represents] the current state of the law in Ohio. Specifically, the *Heine* court's more recent application of the internal affairs doctrine to a breach of fiduciary duty claim, rather than a choice of law provision, appears to accurately state the current law of Ohio on this point. Moreover, the facts and reasoning in *Boyle* are slim . . . . Significantly, *Boyle* was decided in 1992, years before the host of decisions applying the law of the state of incorporation to veil piercing claims.").

<sup>5</sup> See *Johnson*, 2011 BL 252073 at \*9-10 2011 WL 4533198, at \*8 (citing *Batchelder v. Nobuhiko Kawamoto*, 147 F.3d 915 (9th Cir. 1998) and *Nedlloyd Lines B.V. v. Super. Ct.*, 3 Cal. 4th 459 (1992)).

<sup>6</sup> See, e.g., *State Farm Mut. Auto Ins. Co. v. Super. Ct.*, 114 Cal. App. 4th 434, 447 n.3 (2003) ("In upholding [Section 2115], the [Wilson v. Louisiana-Pac. Resources, 138 Cal. App. 3d 216 (1982)] court, in a single sentence of dictum, criticized the internal affairs doctrine. But, in the 20 years since *Wilson* was decided, the internal affairs doctrine has received broad acceptance by the courts and state legislatures."); *Louart Corp. v. Arden-Mayfair, Inc.*, Civ. No. C-192-091, at Conclusion of Law No. 7 (1978) (unpublished) (holding that Section 2115 violates the Commerce Clause); *Vantagepoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1115 (Del. 2005) (deeming Section 2115 unconstitutional due to its extraterrito-

did it consider that the internal affairs doctrine may be constitutionally mandated, as evidenced by the U.S. Supreme Court's disparate treatment of states' corporate statutes based on whether they affect companies in more than one state.<sup>7</sup> In *Edgar v. MITE Corp.*, the U.S. Supreme Court used the Commerce Clause to strike down an Illinois anti-takeover statute that was applicable to foreign target companies, and it warned that "only one state should have the authority to regulate a corporation's internal affairs . . . because otherwise a corporation could be faced with conflicting demands." Similarly, in *Kamen v. Kemper Fin.*, the U.S. Supreme Court barred federal courts from superimposing a universal-demand rule upon all states because it would disrupt companies' internal affairs. It reasoned that the "[u]niform treatment of directors, officers and shareholders is an important objective which can only be attained by having the rights and liabilities of those persons with respect to the corporation governed by a single law." In *CTS Corp. v. Dynamics*, on the other hand, the U.S. Supreme Court upheld an Indiana anti-takeover statute because it applied to only local compa-

rial reach). The *State Farm* court cited approvingly a U.S. Supreme Court case (*CTS Corp. v. Dynamics*, 481 U.S. 69 (1987)) and a Delaware Supreme Court decision (*McDermott Inc. v. Lewis*, 531 A.2d 206 (Del. 1987)), both of which support an overruling of Section 2115, including by quoting at length *McDermott's* discussion of the constitutional imperatives of the internal affairs doctrine and calling it the "best explan[ation]" of that doctrine. 114 Cal. App. 4th at 443-44. Since *Johnson* was decided, at least one California court has evinced its dissatisfaction with Section 2115. See *Lidow v. Super. Ct.*, 206 Cal. App. 4th 351, 363 (2012) ("This court agrees that the voting rights of shareholders, just like the payment of dividends to shareholders and the procedural requirements of shareholder derivative suits, [all of which are covered by Section 2115,] involve matters of internal corporate governance and thus, fall within a corporation's internal affairs.") (internal citations omitted).

<sup>7</sup> See *Edgar v. MITE Corp.*, 457 U.S. 624, 645-46 (1982); *CTS Corp. v. Dynamics*, 481 U.S. 69, 89-90 (1987); *Kamen v. Kemper Fin.*, 500 U.S. 90, 106 (1991); see also *McDermott Inc. v. Lewis*, 531 A.2d 206, 216 (Del. 1987) ("[A]pplication of the internal affairs doctrine is not merely a principle of conflicts law. It is also one of serious constitutional proportions . . .").

nies. It stated that "[t]his beneficial free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the state of its incorporation."

Notably, none of the aforementioned cases (whether or not they apply the incorporating state's law) discuss how elevating contractual choice of law provisions over the internal affairs doctrine can cause unintended consequences for companies and their executives and shareholders. For example, executives of the same company could face inconsistent fiduciary duty standards based on their choice of different jurisdictions' law if executives' fiduciary duty standards were contractually determined. And because the law setting forth executives' fiduciary duty standards would be discovered only through their employment agreements, shareholders and other stakeholders might find it difficult to police executives' performance. Moreover, a race to the bottom could ensue as executives seek application of fiduciary duty law more lenient than that of the incorporating state. Courts should consider these and other potential consequences that may flow from giving contractual choice of law provisions dispositive weight in internal affairs cases.

Because it is unclear whether courts will uniformly apply the internal affairs doctrine over conflicting contractual choice of law provisions, parties should be careful when drafting such provisions. One way to avoid issues addressed in this article is to include language in choice of law provisions stating that they "shall apply without regard to conflict of law principles other than the internal affairs doctrine." Similarly, these provisions can specify that they do not govern the performance of executives' fiduciary duty standards. And executives might consider including in their employment agreements indemnification and exculpation clauses tracking those in their companies' bylaws and articles of incorporation. Such clauses would provide an added layer of protection in the event an adversary seeks application of a state's law that grants weaker legal protections.