

Business Combination Antitakeover Statutes: The Unintended Repudiation of the Internal Affairs Doctrine and Constitutional Constraints on Choice of Law

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I. INTRODUCTION

The decade of the 1980s witnessed a dramatic increase in both the total number and financial size of corporate takeovers.¹ Many changes of control, especially those that were hostile, replaced existing managements with new ones. New managers, motivated by different business strategies, often significantly restructured the acquired corporations, selling off or shutting down individual plants, entire divisions or subsidiaries. Even in friendly takeovers, when existing managements remained in place, the need to repay funds borrowed to accomplish the acquisition frequently required asset sales to raise the necessary cash. Restructurings transferred the effects of takeovers from Wall Street, the marketplace for corporate control transactions, to the towns of the nation and the work places of ordinary citizens.

The resulting turmoil produced a backlash in the state legislatures. Incumbent managements, threatened with the loss of their positions, joined with employee organizations protecting their members' jobs, and with local government representatives fearful of plant closings that would erode the local tax base, to lobby state legislatures. Their combined efforts led to the enactment of state antitakeover statutes.²

These statutes, designed purportedly to protect shareholders from coercive tender offers³ and deter highly leveraged "bust up" takeovers,⁴ operate in

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¹ Total acquisition activity rose from 1558 transactions totaling \$34.8 billion in 1980 to a peak of 4448 transactions in 1986 and a peak value of \$249.7 billion in 1989. RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 34 (1993).

² Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 (1988).

³ The paradigm of a coercive two-tier tender offer is one in which the offeror makes a cash tender for 51% of the stock and threatens a second step squeeze out merger which will compel the remaining 49% to accept securities of considerably less attractiveness than the

various ways. Some early ones regulated the substantive fairness of the hostile bid.⁵ The succeeding generation, "control share acquisition" statutes, stripped voting rights from the hostile bidder's shares (subject to restoration by a disinterested shareholder vote).⁶ While a still later type (and the subject of this Article), the "business combination" statute, allowed the change of control to proceed unimpeded but restricted access by the new owners to the target's assets, inhibiting the sale of manufacturing plants or other assets to pay off acquisition debt.⁷

However these statutes worked, they faced immediate constitutional challenges from hostile bidders. Challenges to their validity relied upon the Supremacy Clause⁸ and Commerce Clause.⁹ The Supremacy Clause challenges claimed that the Williams Act¹⁰ had preempted the field of hostile tender offers, or at least that Congress had declared a firm policy in favor of a level playing field between insurgents and incumbents and that these statutes tilted the field too far in favor of incumbent managements.¹¹ Whether Congress intended merely that the Williams Act not tilt the level playing field, or instead that states not tilt it either, remains an open question.¹² This Article only briefly treats the Supremacy Clause, which provides another constitutional basis to attack these statutes, because preemption is not germane to the problem I have identified. In addition, the Court has yet to delineate the extent of

partial cash offer. Even a shareholder that views the cash consideration as inadequate must tender to protect against the likely possibility that enough of the other shareholders will tender to allow the offeror to obtain 51% and control. The offer creates a type of prisoner's dilemma for shareholders unable to effectively communicate and coordinate their responses.

⁴ Highly leveraged takeovers create strong incentives to break up the target by selling assets to pay off acquisition debt. Breaking up the target company disrupts the expectations of employees and local communities when plants may be closed or payrolls reduced.

⁵ See Note, *Director Conflict of Interest Under the 1983 B.C.A.; A Standard of Fairness*, 1985 U. ILL. L. REV. 741.

⁶ Robert C. Rasmussen & Jeffery M. Fuller, *Florida Takeover Law: Control-Share Acquisitions*, 16 FLA. ST. U. L. REV. 103 (1988).

⁷ Elliot J. Weiss, *What Lawyers Do When the Emperor Has No Clothes: Evaluating CTS Corp. v. Dynamics Corp. of America and Its Progeny—Part II*, 79 GEO. L.J. 211 (1990).

⁸ U.S. CONST. art. VI, cl. 2.

⁹ *Id.* at art. I, § 8, cl. 3.

¹⁰ 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1994).

¹¹ *City Capital Assocs. v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del.), *aff'd*, 860 F.2d 60 (3d Cir. 1988); *RP Acquisition Corp. v. Staley Continental, Inc.*, 686 F. Supp. 476 (D. Del. 1988); *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458 (D. Del. 1988).

¹² *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 502 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989).

Williams Act preemption.¹³

Attacks premised on the Commerce Clause have insisted that the provisions found in these statutes discriminated against interstate commerce, imposed burdens on interstate commerce that were excessive in light of the local benefits, or created a danger of inconsistent regulation.¹⁴ At least with respect to dormant Commerce Clause claims premised on the danger of inconsistent regulation, the Court has spoken with considerable clarity.

The first clear pronouncement came in *Edgar v. MITE*.¹⁵ This decision established that state statutes which purport to regulate takeovers of foreign corporations were constitutionally invalid because of the potential threat of inconsistent regulation.¹⁶ Since these corporations would also be subject to the laws of their state of incorporation, as well as the laws of other states with contacts at least as significant as the regulating state, the burden this placed on interstate commerce fatally offended the dormant Commerce Clause.¹⁷

The decision that clarified the application of the dormant Commerce Clause, *CTS Corp. v. Dynamics Corp. of America*,¹⁸ validated an Indiana antitakeover statute which regulated hostile tender offers by relying on the internal affairs doctrine.¹⁹ Ever since *CTS*, courts have upheld as constitutional virtually any provision which appears in a state corporation statute and which affects matters traditionally within the purview of such statutes, such as shareholder voting rights. No matter how much the provision might inhibit takeovers, or even if it might effectively prohibit them altogether,²⁰ courts have been reluctant to intrude into this area of historic state control, especially since states could forbid statutory mergers altogether.²¹

¹³ See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 96 (1987) (Scalia, J., concurring). Preemption analysis is complicated by the view of at least one Justice that § 78, the general antipreemption provision of the Securities Exchange Act of 1934, would limit its impact in this particular area. *Id.*

¹⁴ *Tyson Foods, Inc. v. McReynolds*, 700 F. Supp. 906 (M.D. Tenn. 1988) (Tennessee statute purports to regulate a Delaware corporation), *aff'd*, 865 F.2d 99 (6th Cir. 1989); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022 (W.D. Okla. 1987) (Oklahoma statute purports to regulate a Delaware corporation); see also *Amanda*, 877 F.2d at 505-09.

¹⁵ 457 U.S. 624 (1982).

¹⁶ *Id.* at 645.

¹⁷ *Id.* at 646.

¹⁸ 481 U.S. 69 (1987).

¹⁹ See *infra* part IV for a discussion of the internal affairs doctrine.

²⁰ *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 508 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989). "The Commerce Clause does not demand that states leave bidders a 'meaningful opportunity for success.'" *Id.*

²¹ *Id.* at 506. The court noted that "Wisconsin did not allow mergers among firms

Business combination antitakeover statutes, such as Delaware's title 8, section 203,²² were enacted in the aftermath of *CTS* as the third generation of such legislation. These statutes regulate the ability of bidders to get unfettered access to the assets acquired for the purpose of paying down acquisition debt in leveraged takeovers. According to some commentators, Delaware and other states developed business combination statutes because control share acquisition statutes, of the kind upheld in *CTS*, were viewed as insufficiently protective of incumbent managements.²³

chartered there until 1947. We doubt that it was violating the Commerce Clause all those years." *Id.*

²² DEL. CODE ANN. tit. 8, § 203 (1991). While this Article will focus on this provision, the most significant of such state legislation, a similar analysis would apply to the statutes of other states. Sixteen other states have adopted similar statutes. RONALD GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1094 (Supp. 1994).

See N.Y. BUS. CORP. LAW § 912(a)(5)(A) (1986). This Code section provides, in relevant part: "[A]ny merger or consolidation of such resident domestic corporation *or any subsidiary* of such resident domestic corporation with (i) such interested shareholder" *Id.* (emphasis added).

Because New York has developed the concept of pseudo-foreign corporations as part of its choice of law doctrine, *see infra* text following note 121, and because targets incorporated in New York, unlike Delaware ones, are likely to have substantial contacts with that state, the dormant Commerce Clause analysis will be somewhat more complicated and the constitutional infirmity less compelling, at least when the subsidiary has significant contacts with New York.

See also MD. CODE ANN., CORPS. & ASS'NS § 3-601(e) (1993). This code section provides, in relevant part: "'Business Combination' means: (1) . . . any merger . . . of the corporation *or any subsidiary* . . . (2) Any sale . . . of any assets of the corporation *or any subsidiary*" *Id.* (emphasis added).

See also N.J. REV. STAT. § 14A:10A (Supp. 1995); PA. CONS. STAT. ANN. §§ 2551-2556 (Supp. 1995).

See also WIS. ST. ANN. § 180.1140(4) (West 1992). This code section provides, in relevant part: "'Business Combination' means any of the following: (a) A merger . . . of the resident domestic corporation *or any subsidiary* . . . (b) A sale . . . of the assets of the resident domestic corporation *or a subsidiary*" *Id.* (emphasis added).

²³ Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 113 (1987).

Professor Gilson has made an even stronger claim, that control share acquisition statutes inadvertently work in favor of the hostile acquirer. GILSON, *supra* note 22, at 1074.

The state interest sought to be protected also was different. The Indiana statute at issue in *CTS* sought to protect the benefits received from having the corporate headquarters and its related employment in Indiana, while Delaware sought to protect the revenues received from its corporate franchise tax. *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 473 n.31 (D. Del. 1988). Most Delaware corporations have no significant assets or employees in Delaware.

Business combination statutes operate at the intersection of corporation law, conflicts of law, and constitutional law. Because these statutes prohibit transactions involving the assets of subsidiaries, including foreign subsidiaries, of the domestic parent target corporation, they necessarily implicate more than one jurisdiction of incorporation. The analysis heretofore used to assess their constitutionality fails to recognize the constitutional issues raised by the competing claims to regulate the internal affairs of foreign subsidiaries by two different jurisdictions of incorporation.²⁴ To achieve their objective of prohibiting transactions with the hostile bidder, including those requiring no formal corporate action by the target parent corporation, these statutes purport to control the internal affairs of foreign subsidiaries and implicitly reject the internal affairs doctrine, the doctrine central to the *CTS* decision, which upheld the Indiana control share statute.²⁵

Unlike familiar prohibitions against self-dealing, business combination statutes impose duties on target parent corporations to impose the enacting state's dictates on foreign subsidiaries absent any harm or injury within the mandating states. Such a prohibition usurps the private, "practical" economic power rather than legal power of the target board for the regulatory purposes of the enacting state. It is an extraterritorial exercise of legislative jurisdiction that is fundamentally at odds with a federal system of coequal sovereign states. It represents a unilateral assertion of primacy among equals. By so doing, these statutes challenge and exceed the constitutional limits on a state's selection of a particular choice of law rule.

Parts II and III of this Article lay the foundation for the central argument made here. Part II begins with a review of dormant Commerce Clause doctrine, the principal basis for successful constitutional challenges against state antitakeover statutes. Part III describes the structural operation of the Delaware antitakeover statute, and proceeds to analyze its application in light of the internal affairs doctrine, the consensus choice of law rule, and perhaps the constitutionally required rule, for matters involving the internal governance of corporations.²⁶ The analysis will focus on the Delaware statute because of Delaware's role as the leading state of incorporation.²⁷ Moreover, among business combination statutes, the Delaware provision also has been the most

²⁴ GILSON, *supra* note 22, at 1098.

²⁵ *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987).

²⁶ See Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CAL. L. REV. 29 (1987).

²⁷ ROBERT HAMILTON, *CASES AND MATERIALS ON CORPORATIONS* 169 (4th ed. 1990). Delaware corporations account for nearly one-half of the largest 1000 industrial corporations. *Id.*

widely litigated.²⁸ The transactions described in Part III either completely avoid the statute's reach, rendering it a practical nullity, or, if the statute applies to them, create such a threat of inconsistent regulation that a court must either invalidate it on dormant Commerce Clause grounds or refuse to apply the internal affairs doctrine. Such a refusal does not secure the constitutional validity of these statutes, but instead raises serious and independent constitutional objections, particularly under the Due Process Clause.

Part IV of this Article examines the internal affairs doctrine, one of the few choice of law doctrines which achieves consistent, sound, and predictable results. This doctrine is the key to understanding the problem of inconsistent regulation and the potential for dormant Commerce Clause invalidity. In the Court's consideration of antitakeover statutes, this doctrine has the potential either to absolve these statutes of constitutional infirmities or render them unconstitutional. The control share statute unsuccessfully challenged in *CTS* applied only to the voting rights of shares in the corporation targeted by the tender offer.²⁹ Thus, in *CTS* the Indiana antitakeover statute could invoke only one possible law of internal affairs. All the judicial and academic analyses of business combination statutes that have followed, consistent with the *CTS* Court's analysis, assume that business combination statutes apply only to corporations incorporated in the jurisdiction enacting the statute.³⁰ Yet to be effective, as demonstrated in Part III, these statutes must prohibit not only transactions with the corporation targeted by the tender offer and transactions with its (explicitly covered) subsidiaries, but transactions with its foreign subsidiaries as well.³¹

Part V examines the constitutional constraints on choice of law found in the Commerce, Due Process, Full Faith and Credit, and Equal Protection Clauses. This examination begins with a consideration of the potential for inconsistent regulation, and thus invalidity under the dormant Commerce Clause, created by the way business combination statutes limit or modify the voting rights of shares issued by foreign corporations and the powers of boards of directors of foreign corporations. These departures from the internal affairs doctrine, which would otherwise govern the voting rights of shares and the powers of boards of

²⁸ See *City Capital Assocs. v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del.), *aff'd*, 860 F.2d 60 (3d Cir. 1988); *RP Acquisition Corp. v. Staley Continental, Inc.*, 686 F. Supp. 476 (D. Del. 1988); *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458 (D. Del. 1988).

²⁹ *CTS*, 481 U.S. at 73.

³⁰ Weiss, *supra* note 7, at 219.

³¹ Part V includes a comparative analysis distinguishing the reach of the prohibitions contained in the Delaware antitakeover statute from the superficially similar and long accepted prohibitions against self-dealing transactions, which also extend to transactions with foreign subsidiaries.

directors, occur because these statutes purport to govern the internal affairs of foreign corporations created by the corporation statutes of other states. This attempt to regulate the internal affairs of foreign corporations produces the same danger of inconsistent regulation that the Court found fatal in *MITE*. Both courts³² and commentators³³ have overlooked this troubling potential for inconsistent regulation.³⁴

The remainder of Part V considers the constitutional issues raised by deviations from the internal affairs doctrine as the governing choice of law rule. Constitutional constraints on deviations from choice of law rules originate primarily in the Due Process and Full Faith and Credit Clauses of the Constitution, but the circumstances created by Delaware's antitakeover statute also provide a basis for an equal protection challenge. The analysis of due process and full faith and credit constraints on the extraterritorial assertions of state power implicit in section 203 considers the implications for federalism if the Court were to uphold such statutes. The analysis concludes that these statutes are fundamentally inconsistent with a federal system of coequal sovereign states. The assessment of the vulnerabilities of these statutes to equal protection challenges examines the implicit classifications they make in determining whether the internal affairs doctrine applies to particular foreign corporations. Since the determination turns on the necessity to prevent foreign corporations from escaping the legislative jurisdiction of Delaware, these statutes discriminate against interstate commerce. Such discrimination does not provide a legitimate state purpose sufficient to justify classifications subjected to even minimal rational basis scrutiny.

Ultimately, I conclude that if *CTS's* elaboration of dormant Commerce Clause concerns has not constitutionalized the internal affairs doctrine, then the requirements of a federal system of coequal sovereign states necessitates the promotion of this doctrine to constitutional status. Otherwise the extraterritorial assertions of legislative power by states will recreate the rivalry, competition, and conflict that originally required subordinating the original thirteen

³² "Wisconsin could exceed its powers by subjecting firms to inconsistent regulation. Because § 180.726 applies only to a subset of firms incorporated in Wisconsin, however, there is no possibility of inconsistent regulation." *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 507 (7th Cir.), cert. denied, 493 U.S. 955 (1989).

³³ "There seems little question about the internal affairs nature of these 'business combinations,' and challenges to the application of Maryland law under the commerce clause will be difficult." P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 80; see also GILSON, *supra* note 22, at 1098.

³⁴ One commentator has raised the problem of extraterritoriality. See Donald H. Regan, *Siamese Essays: (I) CTS Corp. v. Dynamics Corp. of America, and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation*, 85 MICH. L. REV. 1865 (1987).

sovereign states to a limited but supreme national government.

II. A HISTORICAL REVIEW OF THE CONSTITUTIONALITY OF STATE ANTITAKEOVER STATUTES

States have enacted three generations of antitakeover statutes. The first generation, struck down by the decision in *MITE* and exemplified by the Illinois statute involved in that case, applied to target foreign corporations, and therefore was held to violate the internal affairs doctrine.³⁵ The second, of the type considered in *CTS*, was an Indiana control share statute that applied only to target domestic corporations, thus adhering to the internal affairs doctrine, and it was upheld.³⁶ The third generation, generically termed business combination statutes, has not yet been challenged in the Supreme Court, but these statutes purport to regulate only target domestic corporations, and on this basis lower courts have upheld them as consistent with the internal affairs doctrine.³⁷ Courts apply the internal affairs doctrine routinely, without discussion, and since these statutes facially apply only to domestic target corporations,³⁸ application of the doctrine "is generally treated as axiomatic."³⁹

A. *The Dormant Commerce Clause*

Under the Commerce Clause,⁴⁰ the Constitution grants Congress the power to regulate interstate commerce, and under the Supremacy Clause⁴¹ federal regulation controls if it conflicts with state regulation. The problem the "dormant Commerce Clause" concept addresses arises when courts must interpret congressional silence. In the absence of congressional action the courts have been left the task of delineating the extent of the self-executing limitations on the permissible extent of state regulation. Without the self-executing limitation premised on congressional silence, states could enact legislation favoring their own commerce to the detriment of other states, which would inevitably retaliate. The ensuing conflict would undermine the federal system. The dormant Commerce Clause doctrine attempts to resolve competing state and federal interests in the regulation of commerce.

In the state antitakeover regulation context, the first attempt to resolve this

³⁵ *Edgar v. MITE*, 457 U.S. 624 (1982).

³⁶ *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987).

³⁷ *Weiss*, *supra* note 7, at 224.

³⁸ *See* DEL. CODE ANN. tit. 8, § 203 (1991).

³⁹ *Kozyris*, *supra* note 33, at 19.

⁴⁰ U.S. CONST. art. I, § 8, cl. 3.

⁴¹ *Id.* at art. VI, cl. 2.

conflict to reach the Supreme Court was *Edgar v. MITE*.⁴² In this case, a hostile bidder challenged the Illinois Business Take-Over Act⁴³ under both the Supremacy⁴⁴ and Commerce Clauses⁴⁵ of the federal Constitution.⁴⁶ The Illinois statute applied to both domestic and foreign corporations that were targets of hostile tender offers and that had substantial contacts with Illinois.⁴⁷ The statute imposed filing requirements on the bidder, provided for a twenty day delay, and authorized a state officer to hold hearings and adjudicate the fairness of the offer. These measures created both further indefinite delay and possibly prevented the tender offer from proceeding at all.⁴⁸

Only a three Justice plurality found the Illinois Act preempted by the Williams Act⁴⁹ under the Supremacy Clause,⁵⁰ and a bare majority of five invalidated it under the Commerce Clause.⁵¹ Relying on *Pike v. Bruce Church, Inc.*,⁵² for its Commerce Clause analysis, the Court ruled that Illinois had no interest either in protecting out-of-state shareholders or in regulating the internal affairs⁵³ of foreign corporations.

⁴² 457 U.S. 624 (1982).

⁴³ ILL. REV. STAT. ch. 121 1/2, para. 137.51-.70 (1979) (repealed 1983).

⁴⁴ U.S. CONST. art. VI, cl. 2.

⁴⁵ *Id.* at art. I, § 8, cl. 3.

⁴⁶ *MITE*, 457 U.S. at 629.

⁴⁷ *Id.* at 627. These contacts were that Illinois shareholders owned at least 10% of the class of equity securities subject to the offer, or any two of the following three conditions: The corporation had its principal executive office in Illinois; the corporation was an Illinois corporation; or the corporation had at least 10% of its stated capital and paid-in surplus represented within the state. *Id.*

⁴⁸ *Id.*

⁴⁹ 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1994).

⁵⁰ *MITE*, 457 U.S. at 639.

⁵¹ *Id.* at 646.

⁵² 397 U.S. 137 (1970).

⁵³ The internal affairs doctrine is incorporated in the Model Business Corporation Act § 106, which provides that:

A foreign corporation shall not be denied a certificate of authority by reason of the fact that the laws of the state or country under which such corporation is organized governing its organization and internal affairs differ from the laws of this State, and nothing in this Act contained shall be construed to authorize this State to regulate the organization or the internal affairs of such corporation.

MODEL BUSINESS CORP. ACT § 106 (1969).

It is also reflected in the Revised Model Business Corporation Act, in which the official comment to § 15.05(c) explains that the section "preserves the judicially developed doctrine that internal corporate affairs are governed by the state of incorporation even when the

The internal affairs doctrine is a conflict of laws principle which recognizes that only one State [the state of incorporation] should have 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.⁵⁴

Because the Act applied to out-of-state shareholders of foreign corporations, so long as the corporation had the requisite contacts with Illinois, the majority found the statute unconstitutional. They found that even though the act might have regulated interstate commerce only indirectly, it imposed a substantial burden on interstate commerce which outweighed its putative local benefits.⁵⁵

The next case to reach the Supreme Court, *CTS Corp. v. Dynamics Corp. of America*,⁵⁶ upheld a second generation⁵⁷ control share antitakeover statute which regulated tender offers by divesting shares acquired by the bidder of their voting rights until a majority of "disinterested" shareholders voted affirmatively to restore these rights. By modifying the voting rights of shares, a matter universally viewed as within the traditional scope of state regulatory power, this statute successfully relied upon the internal affairs doctrine to legitimate its impact on the tender offer process.⁵⁸ Because it applied only to domestic corporations, it lacked the Illinois statute's vulnerability to dormant Commerce Clause attack because it presented no danger of inconsistent state

corporation's business and assets are located primarily in other states." *Id.* § 15.05 official cmt. (1984).

The Restatement (Second) of Conflict of Laws provides a list of matters within the internal affairs doctrine. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 302-309 (1969). These matters include methods of voting, mergers, the right of shareholders to participate in the administration of the affairs of the corporation, the obligations owed by a majority shareholder to the corporation and to minority shareholders, and the existence and extent of a director's or officer's liability to the corporation, its creditors, and shareholders. *Id.*

The Restatement (Second) also invites departure from the internal affairs doctrine with respect to issues which another state has a more significant relationship with the corporation, the transaction, the shareholders, or the parties. RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 302-306, 309 (1969). See *infra* text following note 132. See also Kozyris, *supra* note 33, at 17.

⁵⁴ *Edgar v. MITE*, 457 U.S. 624, 645 (1982).

⁵⁵ *Id.* at 641. A four Justice plurality found the statute unconstitutional because it directly regulated interstate commerce. *Id.*

⁵⁶ 481 U.S. 69 (1987).

⁵⁷ The Illinois statute was considered the first generation.

⁵⁸ *CTS*, 481 U.S. at 89.

regulation, as the *MITE* Court feared.

Commentators have focused on whether the *Pike v. Bruce Church, Inc.*⁵⁹ balancing test for indirect regulation of interstate commerce, upon which the majority opinion in *MITE* relied, remains viable after *CTS*, which failed to cite it, but implicitly incorporated its analysis.⁶⁰ Since *CTS*, most commentators have agreed that if *Pike*, which weighed the burden on interstate commerce against the local benefit, is no longer viable, then so long as antitakeover statutes do not violate the internal affairs doctrine by applying to foreign corporations, they will probably not run afoul of the Commerce Clause.⁶¹

For statutes which violate the internal affairs doctrine and apply to foreign corporations, the kind struck down in *Edgar v. MITE*,⁶² the consequences are clear. In these cases the risk of inconsistent regulation of foreign corporations by the state of incorporation, the state enacting the antitakeover statute, and other states with equal or greater contacts than the regulating state, presents one of the classic dangers the dormant Commerce Clause was designed to thwart.

While the status of the balancing test part of dormant Commerce Clause analysis may be controversial, the other two themes of analysis are not. If a state statute discriminates against interstate commerce or creates an impermissible risk of inconsistent regulation by different states, it will be invalid under the dormant Commerce Clause.⁶³ Antitakeover statutes that create the danger of inconsistent regulation by applying to foreign corporations⁶⁴ have been uniformly held unconstitutional.⁶⁵

⁵⁹ 397 U.S. 137 (1970).

⁶⁰ See Elliott J. Weiss, *What Lawyers Do When the Emperor Has No Clothes: Evaluating CTS Corp. v. Dynamics Corp. of America and Its Progeny*, 78 GEO. L.J. 1655, 1667 (1990); Weiss, *supra* note 7, at 223.

⁶¹ *CTS*, 481 U.S. at 95 (Scalia, J., concurring).

⁶² 457 U.S. 624 (1982).

⁶³ *CTS*, 481 U.S. at 88.

⁶⁴ Business combination statutes which might attempt to avoid the danger of inconsistent regulation by forbidding the creation of foreign subsidiaries would run afoul of the other well-established part of the dormant Commerce Clause, the part that prohibits direct discrimination against interstate commerce. “[A] state statute which by its necessary operation directly interferes with or burdens [interstate] commerce is a prohibited regulation and invalid, regardless of the purpose with which it was enacted.” *MITE*, 457 U.S. at 642 (quoting *Shafer v. Farmers Grain Co.*, 268 U.S. 189, 199 (1925)).

⁶⁵ *Tyson Foods, Inc. v. McReynolds*, 700 F. Supp. 906 (M.D. Tenn. 1988) (Tennessee statute purports to regulate a Delaware corporation), *aff’d*, 865 F.2d 99 (6th Cir. 1989); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022 (W.D. Okla. 1987) (Oklahoma statute purports to regulate a Delaware corporation).

B. Preemption

The principal remaining area of uncertainty involves the extent of preemption by the Williams Act under the Supremacy Clause. At issue is the degree of impact state statutes can have on the tender offer process before they would be preempted. At one extreme is the view that because state law creates corporations, state law could even prohibit tender offers or make their success impossible so long as the means used to achieve these results relied upon the internal affairs doctrine and operated through corporate governance provisions⁶⁶ of the state's incorporation statute.⁶⁷ This was the view taken by the panel of the Seventh Circuit Court of Appeals that decided *Amanda Acquisition Corp. v. Universal Foods Corp. Amanda*, which upheld a Wisconsin statute barring without exception, absent prior approval by the incumbent board, any merger between the bidder and target for a period of three years following the hostile takeover.⁶⁸ Judge Easterbrook noted that Wisconsin did not allow any mergers at all between Wisconsin corporations until 1947 and doubted that Wisconsin had been violating the Commerce Clause all that time. "As late as 1886 the leading corporate law treatise stated unequivocally that business combinations required the *unanimous* consent of shareholders."⁶⁹ (A requirement of unanimity for shareholder action in a public corporation is the practical equivalent of a flat prohibition.) Not until after the first third of this century did merger authorizations by less than unanimity become the norm.⁷⁰ Easterbrook also observed that Wisconsin could exceed its powers by subjecting firms to inconsistent regulation, but because the statute⁷¹ applied "only to a subset of firms incorporated in Wisconsin, however, there is no possibility of inconsistent regulation."⁷²

⁶⁶ The governance provisions of incorporation statutes delineate the powers and functions or rights and obligations of officers, directors, and shareholders. They have been long recognized as within the provenance of the states, are of unquestioned validity, and often antedate the U.S. Constitution.

⁶⁷ *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 503 (7th Cir.), cert. denied, 493 U.S. 955 (1989).

⁶⁸ *Id.* at 509.

⁶⁹ RONALD GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 505 (1986) (citing MORAWETZ, *A TREATISE ON THE LAW OF PRIVATE CORPORATIONS* 908-09 (2d ed. 1886)).

⁷⁰ *Id.* at 506 (citing William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUNDATION RES. J. 69, 94).

⁷¹ WIS. STAT. ANN. § 180.0726 (West 1992).

⁷² *Amanda*, 877 F.2d at 507. Of course, as I argue in this Article, the Wisconsin statute does apply, to be effective, to foreign subsidiaries, and therefore contains the same fatal characteristic which plagues title 8, section 203 of the Delaware Code.

The other view of preemption, announced by a number of lower courts interpreting the limits of the *CTS* decision, has articulated a balancing test for preemption.⁷³ These courts ask whether a tender offer, despite the hindrance of the antitakeover statute, still has a “meaningful opportunity for success,”⁷⁴ an empirical question for which no data exists. In the absence of data, courts have answered this question in the abstract, and with the burden of proof on the party claiming preemption, the lack of data has proved fatal.

The issue of preemption remains an open one, at least as far as where to draw the line. While preemption arguments have been made against the Delaware statute, none have as yet succeeded. This Article’s concern is with other constitutional provisions, because the vulnerability of business combination antitakeover statutes to challenges on these bases is both far greater and much clearer.

III. THE OPERATION OF BUSINESS COMBINATION ANTITAKEOVER STATUTES

For business combination antitakeover statutes to effectively prohibit second step transactions, these statutes must not only apply to the target, but to all of its subsidiaries as well. These statutes operate by prohibiting second step squeeze out mergers⁷⁵ or equivalent transactions which enable a bidder with

⁷³ *City Capital Assocs. v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del.), *aff’d*, 860 F.2d 60 (3d Cir. 1988); *RP Acquisition Corp. v. Staley Continental, Inc.*, 686 F. Supp. 476 (D. Del. 1988); *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458 (D. Del. 1988).

⁷⁴ *RP Acquisition*, 686 F. Supp at 482; *BNS*, 683 F. Supp at 469.

⁷⁵ One example of such a transaction would be a reverse subsidiary triangular merger. In this transaction, a wholly owned subsidiary of the acquiring firm (capitalized with stock of the acquiring firm) merges with the target and the target survives. The initial step is a tender offer, used by the acquiring firm to purchase a majority (assume 51%) of the target. The acquiring firm then replaces the target’s incumbent board, so thereafter the board resolutions and shareholder votes necessary to authorize the merger become mere formalities. The plan of merger provides that the public shareholders of the target receive as merger consideration shares in the public acquiring firm, while the parent shareholder (the acquiring firm) of the other merger party (the wholly owned subsidiary of the acquiring firm) receives shares in the target. Since the acquiring firm now owns all the outstanding shares of the target, the target has become a wholly owned subsidiary of the acquiring firm. The acquiring firm can then sell off its new subsidiary’s assets to pay down the acquisition debt without having to share the cash proceeds with the former minority shareholders of the target, who have become shareholders in the public acquiring firm. In Delaware, the hapless former minority shareholders in the target cannot even dissent from the plan of merger and seek appraisal rights, the right to a judicial valuation of their shares and payment in cash. In a Delaware corporation, appraisal rights do not exist when the

majority control to become the exclusive owner of targeted assets while requiring the minority interest to accept different consideration, typically securities of some kind, for its minority interest. The acquirer can then sell the target assets for cash, all of which it can distribute to itself, and then use the cash to pay down the acquisition debt. Without using the prohibited business combination, the acquirer can still sell the assets and distribute the cash. However, the acquirer cannot exclude the minority shareholders from receiving their pro rata share of the cash. The intermediate step of the business combination enables the acquirer to pay off the minority in paper rather than cash.

Business combination antitakeover statutes have survived constitutional challenges⁷⁶ so far because following the guidance of *CTS*,⁷⁷ they appear to apply only to domestic corporations. The Commerce Clause basis for challenge that succeeded in *MITE*, the inconsistent regulation basis, has been cursorily examined and a fatal flaw overlooked. Apparently, both courts and litigators have assumed that, because business combination statutes purport to govern only domestic corporations, this particular ground was unavailable.⁷⁸ Yet a closer examination of these statutes reveals the same problem of inconsistent regulation that doomed the Illinois statute in *Edgar v. MITE*.

The Delaware statute⁷⁹ prohibits certain transactions between the

shareholders of a public corporation receive shares of stock in the corporation surviving the merger or shares of stock in another public corporation. DEL. CODE ANN. tit. 8, § 262(b)(1) (1991).

To evade § 203 requires a more sophisticated version of this basic transaction using foreign subsidiaries of the target. Part III describes such a transaction.

⁷⁶ *City Capital Assocs. v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del.), *aff'd*, 860 F.2d 60 (3d Cir. 1988); *RP Acquisition Corp. v. Staley Continental, Inc.*, 686 F. Supp. 476 (D. Del. 1988); *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458 (D. Del. 1988).

⁷⁷ Delaware enacted the most significant of these statutes, title 8, § 203 of the Delaware Code, the year after the Court decided *CTS*.

⁷⁸ In discussing the Wisconsin statute involved in *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 507 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989), the Seventh Circuit wrote: "Because § 180.726 applies only to a subset of firms incorporated in Wisconsin, however, there is no possibility of inconsistent regulation." *Id.* at 507.

The Delaware statute has been similarly interpreted: "Section 203 does not subject interstate activities to inconsistent regulations. It is a Delaware law regulating only Delaware corporations." *RP Acquisition*, 686 F. Supp. at 487.

⁷⁹ The Delaware statute is both the most important and most widely litigated, so the following discussion will concentrate on it. The statute of any other state purporting to prohibit or regulate transactions involving a foreign subsidiary of the target without effects within its jurisdiction suffers from the same problem.

“interested stockholder,”⁸⁰ i.e., the acquiring firm, and any *majority owned subsidiary of the target*.⁸¹ The problem of inconsistent regulation arises because these subsidiaries need not be incorporated in the same jurisdiction as the parent corporation, thus implicating the laws of a second jurisdiction.

If the statute were limited in its application to only majority owned *Delaware* subsidiaries, it would avoid any problem with the internal affairs doctrine and avoid invalidity under the dormant Commerce Clause because of its potential for inconsistent regulation. Interpreted in this manner, the statute would become constitutional, but in light of the purpose for which it was adopted, it would also become wholly ineffective.

If limited in application to Delaware subsidiaries, then the use of foreign subsidiaries allows the interested stockholder to completely evade the statute. The use of foreign subsidiaries cannot be prohibited by Delaware because this prohibition would directly discriminate against interstate commerce. Direct discrimination of this kind unquestionably violates the dormant Commerce Clause.⁸²

Classic internal affairs doctrine holds that the internal affairs of the subsidiary should be governed by its state of incorporation, not the state of its parent. The *MITE* Court held that the application of the Illinois statute to non-Illinois corporations violated the dormant Commerce Clause because of the danger of inconsistent regulation.⁸³ The application of business combination statutes enacted by the target parent’s jurisdiction of incorporation to foreign

⁸⁰ DEL. CODE ANN. tit. 8, § 203(c)(5) (1991).

⁸¹ Title 8, § 203(c)(3) of the Delaware Code defines a business combination as one including:

(i) Any merger or consolidation of the corporation or any *direct or indirect majority-owned subsidiary* of the corporation with (A) the interested stockholder, or (B) with any other corporation if the merger or consolidation is caused by the interested stockholder and as a result of such merger or consolidation subsection (a) of this section is not applicable to the surviving corporation;

(ii) any sale, lease, exchange, mortgage, pledge, transfer or other disposition (in one transaction or a series of transactions), except proportionately as a stockholder of such corporation, to or with the interested stockholder . . . of assets of the corporation or of any *direct or indirect majority-owned subsidiary* of the corporation which assets have an aggregate market value equal to 10% or more of either the aggregate market value of all the assets of the corporation . . . or the aggregate market value of all the outstanding stock of the corporation.

Id. § 203(c)(3) (emphasis added).

⁸² *Edgar v. MITE*, 457 U.S. 624, 643 (1982).

⁸³ *Id.* at 643.

subsidiaries of the target poses the identical potential of inconsistent regulation. Not only does this potential for inconsistent regulation exist, but counsel for the hostile bidder can deliberately create this conflict. In *CTS* the Court reasoned that:

So long as each State regulates voting rights only in the corporations it has created, each corporation will be subject to the law of only one State. No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.⁸⁴

Antitakeover control share statutes of the kind upheld by the Court in *CTS* avoid difficulty with the internal affairs doctrine. Control share statutes strip voting rights from the shares of the target acquired by a hostile bidder through a tender offer. Because these statutes affect only the voting rights of the target's shares, without control of the parent, there is no control of subsidiaries. The operation of business combination statutes is neither so straightforward nor bounded. Business combination statutes allow control over the target to pass unimpeded but restrict the permissible transactions between the acquirer and the target's assets after the control succession. To be effective, the manner in which this restriction operates must violate the internal affairs doctrine.

A. *The Delaware Example—Section 203*

The transaction illustrated in Figure 1 shows the initial steps required to evade the Delaware statute and raise the dormant Commerce Clause problem. In a partial tender offer, a hostile bidder (and non-Delaware corporation) acquires fifty-one percent of the target's stock, achieving voting control of the target Delaware corporation. Since the bidder fails to meet any of the exemptive requirements of section 203(a), it does not escape the prohibitions of section 203(c)(3). Immediately after acquiring control⁸⁵ the bidder can replace all incumbent directors with its own nominees. In the first of three steps, the successful bidder transfers all the assets of the target to a foreign wholly owned subsidiary⁸⁶ of the target (the "Foreign Asset Subsidiary"), elevating the target

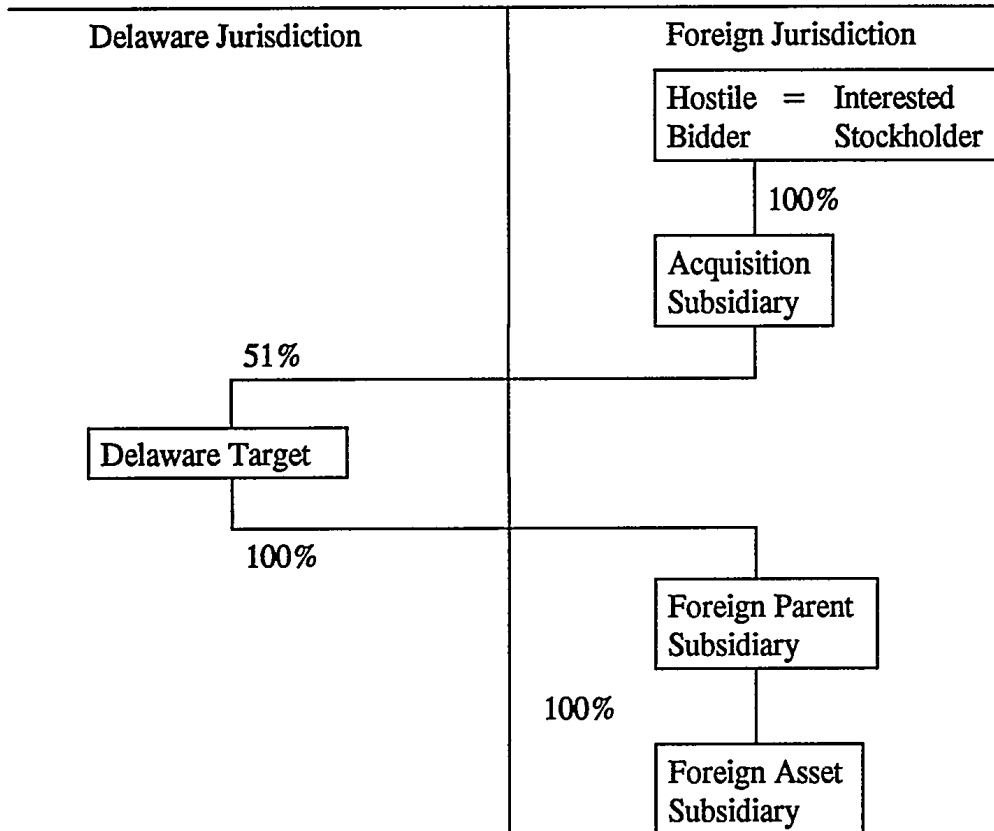
⁸⁴ *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987).

⁸⁵ Assume no charter provisions prevent immediate removal of the incumbent boards of directors of the target and all its subsidiaries. A classified board combined with director removal only for cause could delay gaining control of the board. Even with these defenses, holdover directors might resign instead of seeking to thwart the wishes of a new controlling shareholder and risking substantial personal liability with only the mandatory indemnity provisions of title 8, § 145(c) of the Delaware Code upon which to rely.

⁸⁶ A substantial company would usually already have existing foreign subsidiaries that

to a holding company whose sole asset consists of the stock of the foreign subsidiary. In the second step, the acquirer creates a second foreign subsidiary and transfers the stock of the first foreign subsidiary to it (the "Foreign Parent Subsidiary"), placing a foreign subsidiary holding company between itself and the foreign subsidiary corporation now owning the target assets.

Figure 1
Preliminary Transactions



The Delaware statute prohibits none of these initial steps because none fall within the definition of a prohibited business combination⁸⁷ with an interested stockholder.⁸⁸ An attempt to amend the statute to prohibit a transfer of assets to a foreign corporation would constitute such a direct discrimination against interstate commerce that it would run afoul of another strand of dormant Commerce Clause analysis.⁸⁹

could be used for this purpose.

⁸⁷ DEL. CODE ANN. tit. 8, § 203(c)(3) (1991).

⁸⁸ *Id.* § 203(c)(5).

⁸⁹ CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 88 (1987).

The third and final step, which either evades the Delaware statute⁹⁰ or creates for it constitutionally fatal complications, consists of one of three possible alternative transactions (shown in Figure 2) between the hostile bidder, now the interested stockholder, and the Foreign Asset Subsidiary that now owns the target's assets. Section 203 purports to prohibit each of these alternative transactions.

The alternative transactions are (1) a sale of substantially all the assets of the Foreign Asset Subsidiary to the interested stockholder's wholly owned subsidiary, (2) a statutory merger between the Foreign Asset Subsidiary and a wholly owned subsidiary, the "acquisition subsidiary," of the interested stockholder, or (3) a partial sale of assets by the Foreign Asset Subsidiary to the interested stockholder's wholly owned subsidiary exceeding in value ten percent of either the market value of all the assets of the target or the stock market value of the target.⁹¹ Each of these transactions allows the interested stockholder to acquire assets in exchange for securities it can issue and in turn sell the assets for cash and retain all the cash proceeds for its sole use. The economic effect is to force the target's minority shareholders to provide financing for the interested stockholder's leveraged acquisition of the Delaware target.

B. *Sale of Substantially All Assets or Statutory Merger*

A sale of substantially all the target's assets by its Foreign Asset Subsidiary to the interested stockholder requires both board approval by the Foreign Asset Subsidiary and approval by its shareholder, the Foreign Parent Subsidiary.⁹² Statutory mergers require the same authorization procedures.⁹³ Section 203 purports to prohibit either transaction which enables the interested stockholder⁹⁴ to acquire the desired assets for its own stock, and it can then sell

⁹⁰ Each of these transactions would raise potential self-dealing or conflict of interest issues for the interested stockholder. For discussion of the jurisdictional distinction between business combination statutes and statutes or judicially created doctrines regulating conflict of interest transactions, see *infra* text accompanying notes 201-07. If these transactions could be enjoined because they could not be shown to be fair to minority shareholders, then § 203 would be unnecessary.

⁹¹ DEL. CODE ANN. tit. 8, § 203(c)(3)(ii).

⁹² See *id.* § 271; see also MODEL BUSINESS CORP. ACT § 12.02 (1984).

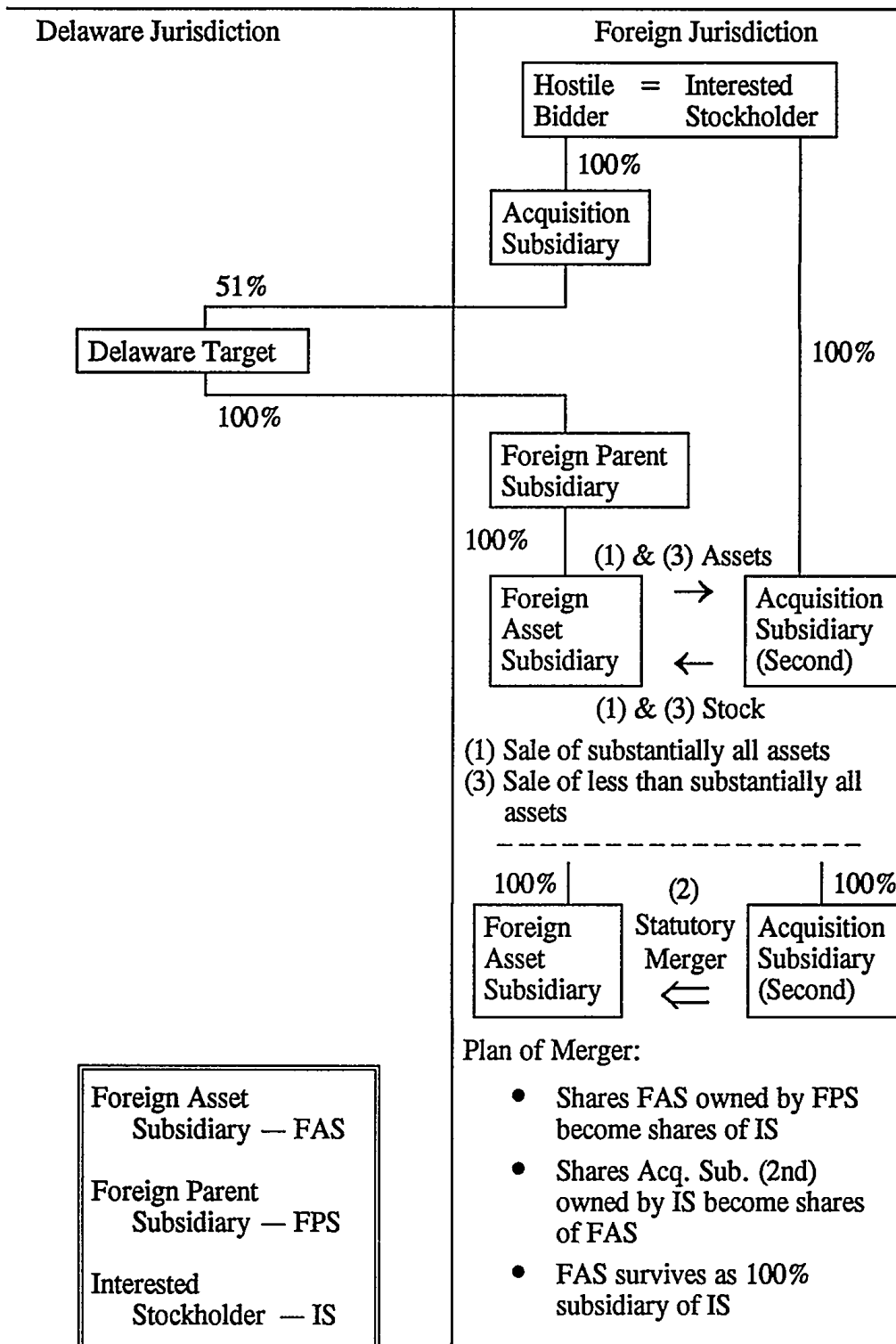
⁹³ See *infra* note 94 for a full elaboration of the steps necessary to accomplish the merger.

⁹⁴ The hostile bidder, the interested stockholder, would typically use a wholly owned acquisition subsidiary as its acquisition vehicle. This subsidiary would merge with the Foreign Asset Subsidiary and the Foreign Asset Subsidiary would be the surviving corporation. The Plan of Merger would typically provide that the stock of the acquisition

these assets for cash which it can use to pay down the acquisition debt. When combined with the earlier step of transferring the assets of the target to the Foreign Asset Subsidiary, owned in turn by the Foreign Parent Subsidiary, each alternative transaction functions as the equivalent of the interested stockholder's purchase of the unwilling minority's share of the Delaware target's assets for its stock instead of cash.

subsidiary would become stock of the Foreign Asset Subsidiary and the stock of the Foreign Asset Subsidiary would become stock of the interested stockholder (which was the stock used to capitalize the acquisition subsidiary).

Figure 2
Business Combinations



C. Partial Sale of Assets

Section 203 includes in its definition of a prohibited business combination any sale by a subsidiary of the target to the interested stockholder of assets whose market value comprises more than ten percent of the aggregate market value of either all the assets or all the outstanding stock of the target corporation.⁹⁵ If the Foreign Asset Subsidiary owns all the target assets, then a prohibited sale would include one of more than ten percent and less than substantially all the assets. Under typical corporation statutes, such a transaction does not require shareholder authorization,⁹⁶ but merely authorization by the board, which in this case was previously installed by the interested stockholder.⁹⁷ Conceivably, such a large transaction could be accomplished without board authorization if the board had previously delegated sufficient authority to its corporate officers.

These alternative configurations of business combinations with the interested stockholder are all prohibited by section 203. None of these transactions require any formal board or shareholder action by the Delaware target. The execution of all three requires only board and shareholder action by boards of and shareholders in foreign corporations. For Delaware to prohibit these transactions, its law must supplant the law ordinarily governing the powers and duties of boards of directors and shareholders, matters usually within the internal affairs doctrine. In extending its law to govern these transactions, Delaware breaches its own conception of the internal affairs doctrine. That conception is the subject of Part IV.

⁹⁵ DEL. CODE ANN. tit. 8, § 203(c)(3)(ii).

⁹⁶ The equivalent provision of the Delaware Code is title 8, § 271. The question of what constitutes "all or substantially all" of the assets involves consideration of both the quantity and quality or significance of the assets, as well as potentially complex valuation issues. *See Gimbel v. Signal Cos.*, 316 A.2d 599, 605 (Del. Ch.) (ruling that a sale of less than one-half of the assets of the corporation was not substantially all, making shareholder approval unnecessary), *aff'd*, 316 A.2d 619 (Del. 1974); *Katz v. Bregman*, 431 A.2d 1274, 1276 (Del. Ch. 1981) (ruling that a sale of more than one-half of the assets of the corporation was substantially all the assets of the corporation and required shareholder approval).

The analogous provision of the Revised Model Business Corporation Act, § 12.02, requires the board of directors of the corporation to propose, and the shareholders to approve, a disposition (not in the ordinary course of business) of all or substantially all the assets of the corporation. MODEL BUSINESS CORP. ACT § 12.02 (1984).

⁹⁷ After the initial tender offer the interested stockholder owns 51% and controls the target corporation. The target, as the sole shareholder of the Foreign Parent Subsidiary, installs its board, which in turn as the sole shareholder of the Foreign Asset Subsidiary installs that board, which then proceeds to authorize the sale.

IV. DELAWARE'S INTERNAL AFFAIRS DOCTRINE

The CTS Court virtually constitutionalized the internal affairs doctrine⁹⁸ so that each corporation would be subject to the laws of only one state.⁹⁹ It recognized that “[n]o principle of corporation law and practice is more firmly established than a State’s authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.”¹⁰⁰ Delaware, because it has few other contacts with the corporations it charters, adheres strongly to this doctrine, deeming it “mandated by constitutional principles, except in the ‘rarest situations.’”¹⁰¹ Yet in its application to foreign subsidiaries, Delaware’s section 203 violates the fundamental tenets of its own internal affairs doctrine.¹⁰²

Delaware has already explicitly rejected the regulation of the voting rights of shares based on the ownership of those shares by a Delaware corporation. In *McDermott Inc. v. Lewis*,¹⁰³ the Delaware Supreme Court ruled that a Delaware subsidiary which owned shares of its Panamanian parent corporation could, contrary to Delaware law and that of any other U.S. jurisdiction, vote the shares of its parent, because the law of Panama permitted such action.¹⁰⁴ The controlling law governing the voting ability of a Delaware corporate shareholder was the law of the jurisdiction of incorporation of the corporation issuing the shares, not that of the owner of the shares.¹⁰⁵ Thus, in regulating business combinations, Delaware would look to the foreign jurisdiction of the Foreign Asset Subsidiary to determine whether its shares could properly be voted to authorize its sale or statutory merger.

Arguably, *McDermott* might be consistent with section 203 because *McDermott*, in deciding between whether to apply the law of the parent corporation’s jurisdiction or the law of the foreign subsidiary corporation’s jurisdiction, gave the prevailing weight to the law of the parent corporation.¹⁰⁶ However, unlike the situation with section 203, the parent in *McDermott* was

⁹⁸ Historically, the internal affairs doctrine evolved from the doctrine of *forum non conveniens*.

⁹⁹ CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987).

¹⁰⁰ *Id.*

¹⁰¹ *McDermott Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987).

¹⁰² An antitakeover statute inconsistent with the state’s own choice of law doctrine could create due process and full faith and credit problems. *See* discussion *infra* part V.

¹⁰³ 531 A.2d 206 (Del. 1987).

¹⁰⁴ *Id.* at 212. “No United States jurisdiction of which we are aware permits that practice.” *Id.*

¹⁰⁵ *Id.* at 215.

¹⁰⁶ *Id.*

also the issuer of the stock whose voting rights were involved.¹⁰⁷ Thus, the apparent symmetry with section 203's regulation, by prohibition, of a parent corporation's power to vote shares it owns in a foreign subsidiary in order to prevent approval of a merger or sale of assets, is illusory.

Such symmetry is also dangerously misleading. If Delaware could justify regulation of the internal affairs of a foreign subsidiary (by regulating the voting rights of its shares), because a Delaware corporation owned a majority of the subsidiary's shares, then the state of incorporation of the hostile non-Delaware bidder would have an equal claim to regulate the internal affairs of the Delaware target parent. Upon completion of the successful tender offer and prior to the business combination, the Delaware target would become a majority owned subsidiary of the bidder. If Delaware strained to read *McDermott* as consistent with section 203, then just as Delaware has adopted an antitakeover statute, other states could provide protective cover for hostile bidders with pro-takeover "antidote" statutes. These would nullify section 203, because under this strained reading of *McDermott*, the antidote provisions of the parent majority shareholder's jurisdiction would prevail, rendering section 203 inapplicable. In the absence of the bright line provided by the internal affairs doctrine, the danger of inconsistent regulation would plague the affected corporations.

In another respect as well, section 203 is at odds with Delaware's internal affairs doctrine and implicitly repudiates it. Controlling the internal affairs of the Foreign Asset Subsidiary, by its majority stock ownership exceeds Delaware's definitional scope of its internal affairs doctrine. Delaware defines internal corporate affairs as involving "those matters which are peculiar to the relationship among or between the corporation and its current officers, directors, and shareholders. It is essential to distinguish between acts which can be performed by both corporations and individuals, and those activities which are peculiar to the corporate entity."¹⁰⁸

Because both corporations and individuals can own shares of stock, share ownership is not peculiar to the corporate entity. Thus the regulation of the voting rights of shares based upon their ownership by a Delaware corporation rejects Delaware's own definition of the scope of its internal affairs doctrine.

A. *Implications of Repudiation of the Internal Affairs Doctrine*

The threat of invalidity is not the worst that could happen to section 203. Its validation would create far worse consequences for Delaware. Validation would undermine Delaware's historic and valuable investment in its

¹⁰⁷ *Id.* at 209.

¹⁰⁸ *Id.* at 214 (citations omitted).

corporation law, threatening a significant share of its corporate franchise tax revenues which comprise about seventeen percent of state revenues.¹⁰⁹

The extension of Delaware law to the internal affairs of foreign corporations in this manner would undermine the application of Delaware law to virtually any Delaware subsidiary owned by a foreign parent corporation or to any Delaware target of a hostile bid by a foreign corporation. If Delaware could constitutionally extend its power to regulate the voting of shares issued by foreign corporations simply because Delaware corporations owned these shares, it could, on the same basis regulate the voting of shares owned by Delaware corporations that did not exercise control, as in the case of institutional investors incorporated in Delaware. Moreover, Delaware could arguably regulate the voting of shares in foreign corporations owned by natural persons residing in Delaware, because these shareholders would have only one residence. Other states could adopt the same legislation, with the result that as residency of shareholders shifted, so would the governing law. California, Texas, and New York could extend their corporate governance to Delaware corporations. If the law governing Delaware corporations were determined by the residency of the shareholders owning a majority or some significant plurality or shares, then the primary benefit of incorporation in Delaware, having Delaware law apply, would no longer exist except in the unlikely event that sufficient shareholders permanently resided in Delaware.¹¹⁰ Such a choice of law doctrine would undermine the very interest that Delaware sought to protect by enacting section 203—corporate franchise tax revenues.¹¹¹

Consider how such a doctrine would operate in the context of a merger. Statutory mergers typically require the same procedures as if each corporation were authorizing a sale of substantially all its assets.¹¹² Both boards of the merging corporations must recommend the merger to their respective shareholders and both sets of shareholders must vote approval.¹¹³ The requisite majority or supermajority¹¹⁴ necessary to approve the merger is determined, consistent with the internal affairs doctrine, by reference to the law of the respective jurisdictions of incorporation. But if voting rights depend upon the

¹⁰⁹ BNS Inc. v. Koppers Co., 683 F. Supp. 458, 473 n.31 (D. Del. 1988). Franchise fees comprised \$170 million or 17% of gross state revenues. *Id.*

¹¹⁰ The only securely permanent arrangement would come from majority ownership by Delaware prison inmates serving life terms without possibility of parole.

¹¹¹ It also would create devastating consequences for interstate commerce; inconsistent regulation would be the norm. For an analysis of the implications of this for the dormant Commerce Clause, see *infra* part V.

¹¹² See *supra* text accompanying note 96.

¹¹³ MODEL BUSINESS CORP. ACT. §§ 11.01, 11.03 (1984).

¹¹⁴ The requisite amount can typically also be varied within statutory limits by explicit provision in the articles of incorporation.

jurisdiction of incorporation of the corporate owner of the shares, and the Delaware share owner were to sell its stock in the subsidiary to another corporation incorporated elsewhere, then the substantive law of the internal affairs of the subsidiary would change and so might the requirements to authorize the merger.¹¹⁵ If the shares were sold to the public, including numerous corporate institutional investors, it might be impossible at any given moment to decide from which jurisdiction, among the many different corporate shareholders, to draw the governing law. And this ignores the problem of shareholders who are natural individuals. Each of these might have sufficient contacts with several jurisdictions so that there might exist multiple potential domiciles or residencies.

In the context of a hostile takeover involving multiple bidders, when there is rapid turnover of shareholders and accumulation through corporate shells organized by both hostile bidders and arbitrageurs seeking to profit from the bidding competition, not only would the governing law for the internal affairs of the target be difficult to determine and constantly in flux, but interested parties would seek to manipulate which jurisdiction would control.

The application of section 203 to foreign subsidiaries also creates another problem. If, as section 203 implies, the Delaware choice of law rule for the internal affairs of a subsidiary is determined by the state of incorporation of the parent,¹¹⁶ then a New York court adjudicating a dispute involving the internal affairs of a Delaware subsidiary of a New York parent¹¹⁷ would first look to its

¹¹⁵ In a short form merger of the kind in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), whether or not a business purpose is required—to protect minority shareholders of the disappearing subsidiary—depends upon the state of incorporation. *See id.* at 468. Delaware requires no business purpose, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. Super. Ct. 1983), while New York does, *Alpert v. 28 Williams St. Corp.* 473 N.E.2d 19, 24 (N.Y. 1984). Section 203's erosion of the internal affairs doctrine suggests that whether or not a business purpose is required could depend upon the state of incorporation of the parent rather than the subsidiary with the minority shareholders. If the immediate rather than the ultimate parent is determinative, then this permits an easy circumvention of the policies of those states requiring a business purpose.

¹¹⁶ The problem becomes more complex if the subsidiary is only partially owned. From Delaware's standpoint, far more problems are presented by the partially owned subsidiary. Because the transaction described in part III avoids § 203 by creating two tiers of foreign subsidiaries, the Foreign Asset Subsidiary and the intermediate Foreign Parent Subsidiary, it would be a simple matter to make the Foreign Asset as well as the Foreign Parent Subsidiaries partially owned by transferring some share ownership to either another corporation or person not formally affiliated with the interested stockholder.

¹¹⁷ In a partially owned Delaware subsidiary the dispute might involve a conflict between shareholders. *See Rosenmiller v. Bordes*, 607 A.2d 465 (Del. Ch. 1991); *Zion v. Kurtz*, 405 N.E.2d 681 (N.Y. 1980) (New York court applying Delaware law).

own choice of law rules as the state of incorporation of the New York parent. New York's own choice of law rules, the internal affairs doctrine, would look to the state of incorporation of the subsidiary, i.e., Delaware.¹¹⁸ Delaware law would look to the law of the state of incorporation of the parent corporation, i.e., New York law. This creates the classic circularity or *renvoi* problem of conflicts analysis.

Delaware, by enacting section 203, has created a Trojan horse, undermining its own interest in the application of Delaware law to Delaware corporations. Ultimately, its franchise tax revenues would erode as firms chose not to incorporate in Delaware, because such incorporation would no longer guaranteed the application of a sophisticated and well-developed body of law to their internal affairs. Not only would uncertainty be created for the Delaware subsidiaries of foreign parent corporations, but of even greater significance, in the event of a partial hostile takeover of a Delaware target, the law of the hostile bidders jurisdiction might then govern the internal affairs of the Delaware target.

B. *Deviations from the Internal Affairs Doctrine*

It is to avoid these problems that the internal affairs doctrine applies the law of the jurisdiction of incorporation of the corporation issuing the shares whose voting rights are involved. The indeterminacy and flux in choice of law that would prevail without the internal affairs doctrine has been characterized by the Delaware Supreme Court as constitutional in significance:

[A]pplication of the internal affairs doctrine is not merely a principle of conflicts law. It is also one of serious constitutional proportions—under due process, the commerce clause and the full faith and credit clause—so that the law of one state governs the relationships of a corporation to its stockholders, directors and officers in matters of internal corporate governance. The alternatives present almost intolerable consequences to the corporate enterprise and its managers. With the existence of multistate and multinational organizations, directors and officers have a significant right, under the

¹¹⁸ New York does not strictly follow the internal affairs doctrine. Not only does it have pseudo-foreign corporation provisions in its own corporation statute, see *infra* text accompanying notes 123–28, but it also provides resident shareholders of foreign corporations greater access to the shareholders' list than provided by the jurisdiction of incorporation. In *Sadler v. NCR Corp.*, 928 F.2d 48, 54–55 (2d Cir. 1991), this latter provision was upheld as not inconsistent with *CTS* because the New York requirement was not forbidden by the jurisdiction of incorporation (Maryland) and because access to shareholder lists was a well-recognized exception to the internal affairs doctrine, because in this respect differing treatment of shareholders in different states was both practical and did not seriously undermine policies of uniform treatment for all shareholders.

fourteenth amendment's due process clause, to know what law will be applied to their actions. Stockholders also have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs. . . .

. . . .

Thus, we conclude that application of the internal affairs doctrine is mandated by constitutional principles, except in "the rarest situations."¹¹⁹

Following the lead of the U.S. Supreme Court in *CTS*,¹²⁰ the Delaware court alluded to a "rare circumstance" when it might permit deviations from the internal affairs doctrine, but neither court provided any guidance for when such circumstances might exist.¹²¹ The allusions might have been included to account for the uncertain and controversial status of the major deviation from the internal affairs doctrine which exists in corporate law, the pseudo-foreign corporation doctrine.

Under this doctrine, a state applies certain provisions of its domestic incorporation statute to foreign corporations with a majority of their contacts with it. Such contacts include residency of shareholders, location of property, residency of employees, and origin of its sales.¹²²

While only a few states have adopted this doctrine, two that have are the commercially important states of New York¹²³ and California.¹²⁴ Although these statutes have existed for several decades, not one of them has ever been upheld by a federal court. No more than two non-California state courts have cited the leading California decision and no state, including California, appears to have explicitly rejected the internal affairs doctrine.¹²⁵

¹¹⁹ *McDermott Inc. v. Lewis*, 531 A.2d 206, 216-17, (Del. 1987), *quoted in Draper v. Gardner Defined Plan Trust*, 625 A.2d 859, 865-66 (Del. 1993).

¹²⁰ *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 90 (1987) (stating 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.") (emphasis added).

¹²¹ *See McDermott*, 531 A.2d at 218.

¹²² *See generally* CAL. CORP. CODE § 2115 (West 1990); N.Y. BUS. CORP. LAW §§ 1317-1320 (McKinney 1986).

¹²³ N.Y. BUS. CORP. LAW §§ 1301-1320 (McKinney 1986).

¹²⁴ CAL. CORP. CODE § 2115 (West 1990). The constitutionality of this provision was upheld in *Wilson v. Louisiana-Pacific Resources, Inc.*, 187 Cal. Rptr. 852 (Cal. Ct. App. 1982).

¹²⁵ The leading California decision is *Western Air Lines, Inc. v. Sobieski*, 12 Cal. Rptr. 719 (Cal. Ct. App. 1961). A more recent California decision upholding the pseudo-foreign corporation doctrine is *Wilson*, 187 Cal. Rptr. at 863. A recent Delaware Supreme Court decision asserted that "[n]o more than two non-California state courts have cited to

In contrast to insistence on a predominance of contacts with the regulating jurisdiction under the pseudo-foreign corporation doctrine, Delaware's application of section 203 would go far beyond what is already a suspect deviation from the internal affairs doctrine. Both the New York and California statutes exempt public corporations,¹²⁶ whose shareholders, and hence their states of residency, are constantly changing. Section 203 does not. And unlike section 203, the California pseudo-foreign corporation statute specifically excepts application to the wholly owned subsidiary of a public corporation.¹²⁷ Section 203 would apply solely on the basis of majority ownership of a foreign subsidiary. The Supreme Courts of both Delaware and the United States have recognized that mere share ownership is, for choice of law purposes, no contact at all.¹²⁸

Even at a theoretical level section 203's deviation from the internal affairs doctrine is unprecedented and unjustifiable. American choice of law doctrine developed from its historical roots in a crude system of territorial choice of law rules, premised on a theory of vested rights.¹²⁹ This approach "attempted to derive all its rules from the single premise that a right vested under the law of the place of the last event necessary to assertion of the right."¹³⁰ Territorial approaches, both this outmoded one and modern ones, generally recognize the paramount interest of the state of incorporation and sustain the internal affairs doctrine.

After the shortcomings of the vested rights approach became apparent, subsequent theorists proposed alternative theories, the most important of which was Brainerd Currie's interest analysis, that resolved choice of law issues by weighing and balancing each state's interest in applying its own law. Interest analysis provided the underlying premise of the *Restatement (Second) of Conflict of Laws*,¹³¹ which would apply the law of the state with the most significant relationship, i.e., "contacts" to the controversy. This approach is the dominate one currently used by the courts.

the *Western Air Lines* case and none of the states, including California, appear to have rejected the internal affairs doctrine." *Draper v. Gardner Defined Plan Trust*, 625 A.2d 859, 867 n.10 (Del. 1993).

¹²⁶ CAL. CORP. CODE § 2115(e) (West 1990); N.Y. BUS. CORP. LAW § 1320 (McKinney 1986).

¹²⁷ CAL. CORP. CODE § 2115(e)(3).

¹²⁸ See *Edgar v. MITE*, 457 U.S. 624, 645-46 (1982); *McDermott Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987).

¹²⁹ Douglas Laycock, *Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law*, 92 COLUM. L. REV. 249, 252 (1992) (citing JOSEPH H. BEALE, A TREATISE ON THE CONFLICT OF LAWS (1935)).

¹³⁰ *Id.* at 252.

¹³¹ *Id.* at 253 (citing RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1969)).

Contemporary theorists have criticized interest balancing as indeterminate, permitting a court to manipulate the priority of interests to reach a balance that allows it to apply whatever law it wants.¹³² Laycock, a modern territorialist, argues that some form of territorialism is the only basis for specifying choice of law rules that is consistent with the federal structure. He would recognize the primacy of the internal affairs doctrine, not as identifying the primacy of interest of the state of incorporation, but as the situs of a relationship, voluntarily created by investors in a corporation.¹³³

¹³² See Frederic L. Kirgis, Jr., *The Roles of Due Process and Full Faith and Credit in Choice of Law*, 62 CORNELL L. REV. 94, 97 (1976). "[T]he legislative and common-law policies underlying specific rules are very often unarticulated; hence, courts applying interest analysis often speculate and, one sometimes suspects, engage in some creative juggling of policies to reach the desired result." *Id.*

¹³³ Laycock, *supra* note 129, at 323.

One could argue that the collective decision of investors to incorporate the target in Delaware, a private ordering choice, was a contractual choice of law decision, and that thereafter the incorporation of foreign subsidiaries carries into their creation the continuing contractual choice of Delaware law and § 203. But this argument is internally contradictory.

First, who are the parties to the contract, that is, the certificate of incorporation? Under the major theories of the firm, the variants of the entity or concession theory and the nexus of contracts theory, the state of incorporation either creates the corporation as a legal fiction or provides the default provisions for those the private parties either neglect or find too costly to specify themselves. Neither theory would support application of Delaware law. If the corporation is a legal fiction created by the state, the state of creation would not permit some other state's provisions to govern its internal affairs. If the choice of law is left to private ordering, then the state of incorporation would not permit the private parties' choices to be constrained by a state whose sole interest is that it is the state of incorporation of a corporate stockholder two steps removed (through the Foreign Parent and Foreign Asset Subsidiaries) from the entity at issue. For a general discussion of the major theories of the firm, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989).

The second limit on the parties freedom to contractually specify the governing law is found in § 187(2)(b) of the Restatement (Second) of Conflict of Laws:

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2)(b) (1969).

The Restatement looks to whether Delaware law would be contrary to a fundamental policy of the state with a materially greater interest. The state under whose laws the corporate entity is created would have a materially greater interest than a state whose sole interest may be its status as the state of incorporation of the parent of the Foreign Parent

Yet, when it comes to corporate law, even interest balancing generally favors adherence to the internal affairs doctrine. The *Restatement (Second) of Conflict of Laws*, in which this approach has been most comprehensively developed,¹³⁴ supplants the internal affairs doctrine only with reluctance.¹³⁵ This reluctance derives directly from considerations of predictability, equality, and uniformity of treatment of shareholders.¹³⁶ Departures from the internal affairs doctrine are justified only when “absolutely necessary to effectuate an important local policy and when intervention is minor and non-disruptive.”¹³⁷

In identifying the unusual circumstances when the *Restatement* approach might accept departures from the internal affairs doctrine, a leading commentator argues that certain areas of corporate law should be excluded.

[These] hard core areas where “indivisible unity” is paramount should include first and foremost the *rights that attach to corporate shares: voting, obtaining information, inspecting corporate records, and dividends, as well as rights in dissolution and liquidation and in corporate consolidations such as mergers.* Other shareholder matters, such as the validity of stock issues, assessments on or redemptions of shares, *fiduciary obligations, protection of minority rights, transfer restrictions, and the validity of shareholder agreements and voting trusts also fall within this category.* It is here that the considerations of predictability, constancy, and autonomy are strongly reinforced by the requirements of equal treatment.¹³⁸

Despite these concerns for predictability and uniformity, this commentator

Subsidiary of the Foreign Asset Subsidiary in question. To permit Delaware to prohibit what the state of incorporation would permit would be contrary to the other state’s fundamental policy under any theory of the firm. Under an entity theory the state would look askance at Delaware regulating entities created under the second state’s corporation statute. If the second state favors extensive private ordering of corporate affairs under a nexus of contracts theory, it would similarly find it contrary to its fundamental policy that Delaware was limiting the flexibility of parties creating corporations using its own statute.

¹³⁴ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302(2) (1969). “The local law of the state of incorporation will be applied to determine such issues, except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which event the local law of the other state will be applied.” *Id.*

¹³⁵ “The Restatement (Second) quite appropriately uses such words as ‘unusual’ and ‘overriding interest of another state’ to refer to the situation where the law of incorporation—which is ‘almost invariably’ applied and of ‘great significance’—may be circumvented.” Kozyris, *supra* note 33, at 63 (citations omitted).

¹³⁶ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 cmt. e (1969).

¹³⁷ Kozyris, *supra* note 33, at 63.

¹³⁸ *Id.* (emphasis added).

also indicates when, allowing for the *Restatement's* invitation, departure from the internal affairs doctrine might be tolerated. He writes that:

[t]he argument for applying the *lex incorporationis* to management's fiduciary obligations to the corporation and to the shareholders is less compelling. The imposition of the strictest of the potentially applicable standards does not create serious practical problems because it is relatively easy for the fiduciaries to learn about applicable rules and to conform to them.¹³⁹

Besides management's fiduciary duties to shareholders, another area in which departures might be countenanced "encompasses certain corporate rules that both significantly affect creditor rights as well as regulate the internal relationship. This category includes . . . prohibitions against the distribution of corporate assets—such as loans, dividends, stock and repurchases—to shareholders or managers in certain instances."¹⁴⁰

This last category could be interpreted to encompass the kind of business combinations with the interested stockholder that Delaware's section 203 prohibits. But whether deviations might be tolerated in this category or with respect to management's fiduciary duty, the *Restatement's* invitation to supplant the internal affairs doctrine is extended only to a state with a more significant relationship with the entity. That relationship must be grounded in contacts such as shareholder residency, place of business or location of assets. Mere majority share ownership by one corporation in a chain of holdings would never suffice. Such a minimal connection provides no basis to privilege Delaware's policy over the states of incorporation of the Foreign Parent Subsidiary and Foreign Asset Subsidiary, the acquisition subsidiary, or the interested stockholder. Instead, because Delaware typically has few contacts with the corporations it charters, supplanting the internal affairs doctrine with interest analysis poses a major threat to Delaware's investment in its own corporate law. Under this analysis, Delaware corporate law would apply only to those few Delaware corporations with substantial and significant contacts with it.

At least two decisions¹⁴¹ have accepted the *Restatement's* justification for departing from the internal affairs doctrine.¹⁴² In one, the jurisdiction of incorporation's contacts with the underlying claim consisted of only the bare fact of incorporation. In the other, some officers, directors, and shareholders

¹³⁹ *Id.* at 64.

¹⁴⁰ *Id.* at 64–65.

¹⁴¹ *Ficor, Inc. v. McHugh*, 639 P.2d 385 (Colo. 1982); *Francis v. United Jersey Bank*, 392 A.2d 1233 (N.J. Super. Ct. Law Div. 1978).

¹⁴² In both decisions the departure had no effect on the result because the law of the state of incorporation was the same as the law applied.

resided in or near the District of Columbia, the jurisdiction of incorporation. In both cases, all the activities giving rise to the claims and all the property of the corporations were located in the jurisdiction whose law was applied. Neither decision would support the validity of section 203 unless Delaware was the location of the principal business activities and property of the Foreign Asset Subsidiary, an unlikely event given Delaware's role as a jurisdiction of convenience.

In addition, these cases are distinguishable because they involved closely-held corporations. In the context of large, public corporations with shareholders, assets and operations scattered over the entire globe, an interest analysis would create enormous difficulties, especially because the identity of public shareholders constantly shifts. For firms like IBM or AT&T probably several states, perhaps even the great majority, might have sufficient contact with the corporation to justify application of their own law under an interest analysis. As a result, the applicable law for the internal affairs of the entity would be unpredictable. The worst kind of forum shopping would occur. Planning would be disrupted, and shareholders would be treated unequally depending upon their residence or the forum where a suit was brought. In such circumstances, even the *Restatement* could not countenance departure from the internal affairs doctrine.

Compared to the *Restatement*, Delaware, in matters of corporate law, uniformly adheres to the internal affairs doctrine. Even in a closely held corporation the unanimous shareholders cannot supplant the internal affairs doctrine with their own agreed choice of law. A recent Delaware Chancery Court decision, *Rosenmiller v. Bordes*, expressly rejected the notion that parties to a shareholders' agreement could, through contractual choice of law provisions, supersede the internal affairs doctrine.¹⁴³ This Delaware decision is especially significant because such agreements are arguably not even within the internal affairs doctrine,¹⁴⁴ and the *Restatement* views these agreements as

¹⁴³ *Rosenmiller v. Bordes*, 607 A.2d 465, 468 (Del. Ch. 1991).

¹⁴⁴ See *Gries Sports Enters., Inc. v. Modell*, 473 N.E.2d 807 (Ohio 1984), *cert. denied*, 473 U.S. 906 (1985). The Ohio court decided that a voting trust agreement between shareholders was a contract and choice of law principles governing contracts were not within the internal affairs doctrine. *Id.* at 810. In a superficial sense this court was correct, because, under the classic test of the internal affairs doctrine, natural individuals can have contract disputes, and thus this conflict of laws issue is outside the bounds of the internal affairs doctrine. However, voting trust agreements, by the way they control shareholder voting, are unique to corporations and their interpretation arguably ought to be within the internal affairs doctrine. Moreover, since a voting trust agreement in a public corporation might govern thousands of public shareholders residing and executing their agreements in all the 50 states, a failure to apply the internal affairs doctrine means that interpretations of the same agreement might vary, depending upon shareholder residence, producing

particularly amenable to interest analysis.¹⁴⁵ Moreover, until quite recently, corporation statutes did not explicitly refer to shareholder agreements and earlier statutes did not treat them at all.¹⁴⁶

The *Rosenmiller* decision considered a stockholders' agreement between the only two shareholders in a Delaware corporation. The agreement explicitly provided that the validity of a voting provision would be governed by New Jersey law. More than ten years after the agreement's execution, one shareholder sought to invalidate the voting restriction, citing a Delaware provision¹⁴⁷ limiting such voting agreements to a term not exceeding ten years. In its analysis of Delaware's choice of law rules, the court cited section 187 of the *Restatement (Second) of Conflict of Laws*, stating:

That section provides that the parties' choice of law, as expressed in their agreement, will be upheld unless the state whose law would control in the absence of a choice has a materially greater interest in the subject matter. If that is the case, the law of the state with the greater interest will control the outcome of the dispute, and the express choice of law will be of no consequence.

It is well settled that, under the internal affairs doctrine, the state of incorporation has the paramount interest in having disputes of internal corporate governance resolved according to its own laws. Nothing is more central to the internal management of a corporation than a stockholder's right to vote in the election of directors.¹⁴⁸

In adapting interest analysis to its own needs the Delaware court promoted the single contact of being the jurisdiction of incorporation to the paramount interest. It justified this result for the following reasons:

inconsistent results. On the other hand, the same corporation might use a standard form sales contract to deal with its business customers in all the 50 states with potentially the same inconsistent results in these arrangements as well. Therefore, the issue cannot be resolved by formalistic arguments premised on characterization of the dispute as involving either contractual rights or shareholder voting rights, but resolution by delineation of the precise boundaries of the internal affairs doctrine is beyond the scope of this Article.

¹⁴⁵ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 305 cmt. b (1969).

¹⁴⁶ The Revised Model Business Corporation Act explicitly provides for such agreements. MODEL BUSINESS CORP. ACT § 7.31 (1984). The older Model Business Corporation Act did not. MODEL BUSINESS CORP. ACT § 7.32 official cmt. (1995).

¹⁴⁷ DEL. CODE ANN. tit. 8, § 218(a) (1991). It should be noted that 69 Del. Laws, c. 263 (1994) deleted "not exceeding 10 years," substituting "for any period of time determined by such agreement" in the first sentence of § 218(a).

¹⁴⁸ *Rosenmiller v. Bordes*, 607 A.2d 465, 468 (Del. Ch. 1991) (citations omitted).

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. And the Delaware Supreme Court has held that the "application of the internal affairs doctrine is mandated by [these] constitutional principles, except in the 'rarest situations.'"¹⁴⁹

The defendants in *Rosenmiller* argued that their case presented the "rarest situation" excepted in *McDermott*, citing the facts that the parties to the suit represented one hundred percent of the voting stock and had bound themselves and their successors to submit to New Jersey law. The court, while pointing out that neither the U.S. nor Delaware Supreme Courts had provided clarity with respect to what situations were the rarest situations, held that this dispute fell squarely within the internal affairs doctrine. The mere fact that the parties to the shareholders' agreement owned one hundred percent of the stock did not bring it within the "rare" exception.

The court held that Delaware had a greater interest in regulating stockholder rights, even though incorporation in Delaware provided the only nexus with that jurisdiction.¹⁵⁰ The corporation had its principal place of business in New Jersey and conducted much of its business in the state. The Delaware court expressly rejected Ohio authority in which the supreme court of that state held that a voting agreement between stockholders of a Delaware corporation would be tested under Ohio law, because Ohio bore a more significant relationship to the contract than did Delaware.¹⁵¹ The Delaware court held that Delaware had already, in *McDermott*, rejected the *Restatement's* argument that local interests could outweigh the incorporating state's interest in regulating the internal affairs of a domestic corporation, and it declined to depart from the internal affairs doctrine.¹⁵²

¹⁴⁹ *Id.* (citations omitted).

¹⁵⁰ The *MITE* majority noted that "Illinois has no interest in regulating the internal affairs of foreign corporations." *Edgar v. MITE Corp.*, 457 U.S. 624, 645-46 (1982). At least one commentator has argued that "no interest . . . leaves nothing to be placed in the constitutional balance under the test of *Pike v. Bruce Church, Inc.* to justify any state interference in the internal affairs of foreign corporations." Kozyris, *supra* note 33, at 40 (citations omitted). He also argues that regulation without any interest may violate due process as well. *Id.*

¹⁵¹ *Gries Sports Enters., Inc. v. Modell*, 473 N.E.2d 807, 810 (Ohio 1984), *cert. denied*, 473 U.S. 906 (1985).

¹⁵² *Rosenmiller v. Bordes*, 607 A.2d 465, 468-69 (Del. Ch. 1991).

Delaware has rejected even the theoretical basis for departing from the internal affairs doctrine. Its courts have strongly adhered to this doctrine. Delaware's own policy interests require maintaining the doctrine's supremacy. In light of these factors, Delaware courts would be hard pressed to uphold the validity of section 203 when confronted with a challenge posed as in this Article. However, if they were to uphold it as somehow consistent with Delaware's adherence to the internal affairs doctrine, then they provide a strong basis for federal constitutional challenges, the subject of Part V.

V. CONSTITUTIONAL CONSTRAINTS ON THE REACH OF SECTION 203

As a matter of state conflict of laws doctrine, an antitakeover statute that is inconsistent with the internal affairs doctrine does not necessarily create problems of a constitutional magnitude. The Constitution may not require adoption of the internal affairs doctrine as a state's choice of law rule governing its corporate law. Although the Supreme Court's analysis in *CTS* strongly suggests that it may now hold this view, it has yet to clearly and unequivocally promulgate this principle.¹⁵³

The purported prohibition by section 203 of the three transactions illustrated in Part III exceeds Delaware's power to act extraterritorially in a federal system of coequal sovereign states subordinated to a national government with plenary power over interstate commerce. The limits on Delaware's power are found in a number of constitutional provisions: the Due Process,¹⁵⁴ Equal Protection,¹⁵⁵ Full Faith and Credit,¹⁵⁶ and dormant Commerce Clauses.¹⁵⁷ In application, these doctrines are intertwined. All relate

¹⁵³ Certainly, *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987); *Delaware v. New York*, 113 S. Ct. 1550 (1993); and *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90 (1991) strongly suggest this result. *Kamen* held that the law of the state of incorporation governed the substantive legal issues of corporate governance, including the question of presuit demand on the board of directors. In *Delaware*, a case involving the power of a state to escheat intangible property (debts owed by financial intermediaries such as stock brokerage firms to creditors that could neither be found nor for which a last address could be identified), the Court ruled that the escheat power lay with the debtor's state of incorporation (Delaware) and not the state of the debtor's principal executive office location (New York). The Court reached this result because the state of incorporation provided a clear and unambiguous answer, while the principal executive office location could raise factual controversies. This holding further supports the argument that after *CTS*, the internal affairs doctrine is constitutionally required.

¹⁵⁴ U.S. CONST. amend. XIV, § 1.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at art. IV, § 1.

¹⁵⁷ *Id.* at art. I, § 8, cl. 3.

to the extraordinary way Delaware purports to legislate and reach foreign subsidiaries under section 203 with the barest of possible contacts (indirect majority share ownership) with the underlying transaction. Because it results in arbitrary and extraterritorial regulation with an insufficient basis, such a reach exceeds constitutionally permissible limits.

These constitutional constraints are conceptually intertwined because in the context of section 203 they all constrain extraterritorial exercise of state power. The dormant Commerce Clause is invoked to avoid the potential for conflicting regulation by more than one state in circumstances when the effects of the regulatory exercise of power occur both within and without the borders of the regulating states. The Full Faith and Credit Clause regulates the overlapping legislative jurisdictions of two or more states by providing a simple federal rule to determine which of two competing judgments will be honored, provided it was rendered with jurisdiction over the subject matter and parties. Obtaining jurisdiction over subject matter and parties also entails territorial considerations. The Due Process Clause invalidates judgments rendered without jurisdiction and prevents states from being completely free to mandate their own grounds for the extraterritorial extension of their jurisdictional power. Lastly, the constraint the Equal Protection Clause imposes involves territorial concerns because in this context Delaware's classifications of foreign corporations into those to which the internal affairs doctrine applies and those to which it does not is driven by a purpose to prevent the escape of certain corporations from the regulatory jurisdiction of Delaware. Considerations of federalism undergird all of these constitutional provisions and ultimately federalism requires constraints on the exercise of a state's extraterritorial exercise of legislative jurisdiction.

A. *Conflicting Regulation and the Dormant Commerce Clause*

The *CTS* and *MITE* decisions have led both commentators and the Delaware Supreme Court¹⁵⁸ to accord constitutional significance to the internal

¹⁵⁸ *McDermott Inc. v. Lewis*, 531 A.2d 206, 218-19 (Del. 1987). In *McDermott*, the Delaware Supreme Court stated:

[W]e believe that full faith and credit commands application of the internal affairs doctrine except in the rare circumstance where national policy is outweighed by a significant interest of the forum state in the corporation and its shareholders.

. . . Due process requires that directors, officers and shareholders be given adequate notice of the jurisdiction whose laws will ultimately govern the corporation's internal affairs.

. . . For Delaware now to interfere in the internal affairs of a foreign corporation

affairs doctrine.¹⁵⁹ The appeal of this result is understandable and persuasive and largely accounts for the wide adherence to the doctrine. In the absence of a clear alternative rule identifying the applicable law of a single jurisdiction to govern the internal affairs of a corporation, the potential for conflicting regulation creates dormant Commerce Clause bases to invalidate corporate statutes.

For purposes of dormant Commerce Clause analysis, the three alternative transactions identified in Part III have varying degrees of remoteness from Delaware's regulatory jurisdiction. Transactions A and B (i.e., the statutory merger and sale of substantially all assets) require board authorization by the Foreign Asset Subsidiary board and a shareholder vote by its shareholder, the Foreign Parent Subsidiary. Transaction C, the partial sale of assets, is even further removed from the regulatory jurisdiction of Delaware. It requires only board authorization by the Foreign Asset Subsidiary, and conceivably the transaction could even dispense with board authorization if authority had previously been delegated by the board to corporate officers. No formal corporate action is required by the Delaware target parent to accomplish any of these transactions.¹⁶⁰

The prohibition by section 203 of these transactions as business combinations with the interested stockholder creates a conflict between the legislative jurisdiction of Delaware and the legislative jurisdiction of the Foreign Asset Subsidiary's state of incorporation, which would permit the transactions. Section 203 conflicts with the powers and duties assigned to the board of directors and shareholders of the Foreign Asset Subsidiary and Foreign Parent Subsidiary by their jurisdiction of incorporation. That jurisdiction permits these transactions, absent breaches of fiduciary duty. Under

having no relationship whatever to this State clearly implies that International can be subjected to the differing laws of all fifty states on various matters respecting its internal affairs. Such a prohibitive burden has obvious commerce clause implications, and could not pass constitutional muster.

Id.

¹⁵⁹ See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987); *Edgar v. MITE*, 457 U.S. 624 (1982); *McDermott Inc. v. Lewis*, 531 A.2d 206 (Del. 1987); see also Buxbaum, *supra* note 26, at 43-47.

¹⁶⁰ I assume that the interested stockholder, as controlling shareholder after a successful tender offer, has installed the boards of the target and the target's Foreign Parent and Foreign Asset Subsidiaries, and second, that these boards have determined in good faith that the sale of substantially all assets in exchange for stock of the interested stockholder or that the proposed merger consideration of stock in the interested stockholder is sufficiently generous that the proposed transactions are in the best interests of the Foreign Asset Subsidiary.

the internal affairs doctrine, the law of the jurisdiction of incorporation determines the existence, scope and breach of fiduciary duties.¹⁶¹ Section 203 would prohibit the Foreign Asset Subsidiary's board from recommending to its shareholder, the Foreign Parent Subsidiary, a transaction that the board has determined within its business judgment is in the best interests of the corporation. Delaware forbids what the state of incorporation permits.¹⁶²

If, to avoid this conflict over the powers of the Foreign Asset Subsidiary board, a court interpreted section 203 to apply only to prohibit shareholder approval of the transaction by the Foreign Parent Subsidiary shareholder, then it still creates conflict with the laws of a sister state. Because the sole shareholder of the Foreign Asset Subsidiary is the Foreign Parent Subsidiary, section 203, by nullifying or prohibiting the shareholder authorization, purports to govern the shareholder voting rights in a foreign corporation.¹⁶³

If the Foreign Asset Subsidiary sells less than substantially all its assets to the interested stockholder, but enough to trigger the section 203 threshold, as in transaction C; it creates an even more remote and tenuous jurisdictional basis for Delaware regulation. This transaction perhaps best illustrates the extraterritorial reach of the Delaware statute, a reach that, consistent with a federal system of coequal state sovereigns, the Constitution must prohibit. Structured in the manner shown in Figure 2, the transaction requires no formal

¹⁶¹ Fiduciary duties of directors and controlling shareholders are within and governed by the internal affairs doctrine. Kozyris, *supra* note 33, at 24 nn.95-96. See also Maher v. Zapata Corp., 714 F.2d 436, 464 (5th Cir. 1983) (applying a very strong internal affairs principle to a Texas statute subjecting foreign corporations to Texas law on the duties of directors on matters affecting the transaction of interstate business).

¹⁶² One could argue that a true conflict requires a prohibition from one jurisdiction conflicting with a mandate or required action from another. Since modern corporation statutes contain very few mandates and are largely permissive in nature, this approach would avoid a conflict because none of the illustrated transactions would be required by the state of incorporation. However, the Court, concerned with the *potential* for conflicting regulation, has rejected this approach. *MITE*, 457 U.S. at 645-46.

¹⁶³ In the case of the statutory merger, Delaware General Corporation Law, § 203 is inconsistent with § 252. Delaware law permits a merger between a Delaware corporation and a foreign corporation under § 252. DEL. CODE ANN. tit. 8, § 252 (1991). The applicable provision, § 252(c), provides that "[t]he agreement shall be adopted, approved, certified, executed and acknowledged by each of the constituent corporations in accordance with the laws under which it is formed" *Id.* Not only does § 203 purport to regulate a merger between two foreign corporations, the Foreign Asset Subsidiary of the Delaware target and the acquisition subsidiary of the interested stockholder (a third foreign corporation), but it applies Delaware law to nullify or prohibit the merger authorization procedure established by the foreign jurisdiction of incorporation. DEL. CODE ANN. tit. 8, § 203 (1991). This directly contradicts the provisions of § 252 that look to the foreign jurisdiction for that corporation's merger authorization procedure.

corporate action of approval or authorization by the Delaware target to proceed. Only board approval by the Foreign Asset Subsidiary is needed and under the internal affairs doctrine that board approval proceeds according to the laws of its state of incorporation which would not recognize the prohibition of section 203.¹⁶⁴

Delaware's theory of enforcement of section 203 must be that the new board of the Delaware target installed by the interested stockholder has a duty, absent harm to the target,¹⁶⁵ to force a foreign subsidiary to ignore the powers granted by its own state of incorporation and obey the Delaware statute solely because of its indirect ownership by a Delaware corporation. This approach ignores that the Delaware target has become a fifty-one percent subsidiary of the hostile bidder's acquisition vehicle, another foreign corporation. Such a claim to primacy in a federal system composed of coequal sovereign states is untenable.

1. *Section 203's Dormant Commerce Clause Defect Cannot Be Remedied*

Creating the problem of inconsistent regulation, which laid the foundation for the dormant Commerce Clause basis to challenge the Delaware statute, required conveying all the assets of the Delaware target to the Foreign Asset Subsidiary. Delaware could attempt to avoid the problem of inconsistent regulation by including in its definition of prohibited business combinations the conveyance of any assets to a foreign subsidiary corporation. However, this prohibition would violate the dormant Commerce Clause because it would directly discriminate against interstate commerce, because such transfers to a domestic subsidiary would remain lawful.¹⁶⁶ If such a prohibition were constitutionally permitted, then states could hold corporations hostage by generally prohibiting them from moving assets or operations into out-of-state

¹⁶⁴ To make the conflict even more extreme, the board could in general terms delegate power to authorize the transaction to an officer or agent of the Foreign Asset Subsidiary at the time it is formed. Later, when the particular transaction with the interested stockholder is identified, § 203 would purport to revoke authority previously granted.

¹⁶⁵ If there is injury or harm to the Delaware target, then this impact is within the legislative jurisdiction of Delaware and creates a duty for the target board to act consistent with Delaware fiduciary duties. *See infra* text in the section following note 199.

¹⁶⁶ *See* *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 579 (1986) (stating that "[w]hen a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry.") (citations omitted); *Edgar v. MITE*, 457 U.S. 624 (1982).

corporations for any reason. While this would protect the individual state's tax base, it would Balkanize the national economy, precisely the result the Commerce Clause was intended to prevent.

An impractical, though less clearly unconstitutional, solution would treat any transfer of assets to any subsidiary, foreign or domestic, as a business combination requiring compliance with the statute. This might not unreasonably restrain alienation, a basis for invalidity, because the business combination could be approved by compliance with the supermajority provisions of the statute and would be limited in time to the three year period after change of control provided by the statute.¹⁶⁷ Despite the purpose of such an enactment to discriminate against interstate commerce, the Supreme Court has generally refused to consider the invidious legislative purpose behind a neutral statute.¹⁶⁸

Invidious motive aside, there would remain the potential resuscitation of the *Pike*¹⁶⁹ balancing test, which would weigh the burdens on interstate commerce against the local benefits. Such a sweeping definition of a prohibited business combination would impose substantial burdens on interstate commerce. Because Delaware probably would have few other contacts (e.g., location of assets, employees) with the target corporation beyond being its state of incorporation, its local benefit might not suffice to outweigh the burden imposed on interstate commerce and withstand a dormant Commerce Clause challenge.

The more intractable difficulty with this approach to avoiding the problem of inconsistent regulation is a practical one. Many major firms incorporated in Delaware already have major non-Delaware subsidiaries. To come within the protection of the statute, the potential target would have to reincorporate these subsidiaries in Delaware, thereby increasing state franchise tax revenues. While this may not create extreme difficulties for domestic foreign subsidiaries, it might prove unworkable for overseas operations (truly "foreign" foreign

¹⁶⁷ DEL. CODE ANN. tit. 8, § 203(a) (1991).

¹⁶⁸ See *Palmer v. Thompson*, 403 U.S. 217, 224-25 (1971). This decision has subsequently been severely criticized by commentators. The Court perceived great difficulty in ascertaining the individual motives of a group of legislators. It therefore decided to not even inquire into their real motives, because invalidating the action for improper motivation could be corrected by reenactment based upon a proper motive. See also Paul Brest, *Palmer v. Thompson: An Approach to the Problem of Unconstitutional Legislative Motive*, 1971 SUP. CT. REV. 95.

This decision involved an equal protection claim in a racial context. Conceivably a dormant Commerce Clause claim might be treated differently. See John Ely, *Legislative and Administrative Motivation in Constitutional Law*, 79 YALE L.J. 1205 (1970); LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW*, § 5-3, at n.10 (2d ed. 1988).

¹⁶⁹ *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970).

subsidiaries) depending upon the tax and substantive legal regime of the nation where these operations exist. To reincorporate only domestic foreign subsidiaries, leaves those very operations vulnerable that are the most readily sold since they are to some extent already separate and free standing.¹⁷⁰

To compound this practical difficulty, consider a hostile bidder that barely crosses the fifteen percent threshold, merely making a toehold acquisition. Thereafter, the statute, as modified to bar any transfer of assets to even a wholly owned subsidiary, severely constrains the ordinary operations of the target. No intra-company sales or other transactions aggregating more than ten percent of total assets¹⁷¹ could occur without the two-thirds shareholder vote. To escape this prohibition, the statute requires that either the transaction involved or the acquisition of shares by the interested stockholder have been approved by the incumbent board prior to the date that the bidder becomes an interested stockholder, even if board membership is unchanged.¹⁷² All intra-company sales of sufficient size to fall within the statute's scope, such as exports to overseas subsidiaries, would need approval three years in advance of their occurrence without any prior warning that an interested stockholder would emerge to create this problem. The target firm could not export to its overseas subsidiaries without obtaining the two-thirds vote of disinterested shareholders. While this would provide a bonanza for the securities bar and proxy solicitors, it would change section 203 from an intended bastion for Delaware targets into a weapon turned against them.¹⁷³

¹⁷⁰ Perhaps as to these truly foreign subsidiaries Delaware could successfully act extraterritorially with § 203 because the interests of the host foreign nations would not implicate federalism's concern with the coequal sovereignty of the states. However, the host foreign nations' courts would have no obligation under our Full Faith and Credit Clause to recognize any Delaware court judgment with respect to the fiduciary obligations or other constraints that § 203 purports to impose on foreign subsidiaries' boards. These assets also could be conveyed subsequently to domestic foreign subsidiaries by the hostile bidder and they would then be free of § 203's constraints.

¹⁷¹ This situation would arise when captive subsidiaries sell almost exclusively to their parent company.

¹⁷² DEL. CODE ANN. tit. 8, § 203(a)(1).

¹⁷³ Conceivably its use in this manner would so hamper operations that profits would be reduced. A decline in profits would reduce the market price of shares, thus reducing the aggregate stock market value and the total required acquisition price. This reduction in stock market value would bring even more transactions within the scope of § 203, constraining target operations even more, further reducing profits, and creating a spiral of decline. The result would make the target even more attractive because the hostile bidder could anticipate an additional margin of profit to be gained by freeing the target company from these constraints.

2. *Step Transactions*

A second possible remedy for the dormant Commerce Clause problem of inconsistent regulation created by section 203 would seek to maintain the efficacy and validity of section 203 as an antitakeover defense. It would attempt to integrate the separate steps of avoidance described in Part III into a single continuous transaction. The integration of the separate preliminary conveyances to the Foreign Asset and Foreign Parent Subsidiaries, with the subsequent sale of assets or statutory merger between the Foreign Asset Subsidiary and the interested stockholder, would prevent escape from Delaware's legislative jurisdiction. By integrating several steps into one, the application of section 203 to the Foreign Asset Subsidiary becomes more consistent with the internal affairs doctrine, because the assets originally belonged to a Delaware corporation and were conveyed to escape the reach of the statute.

This argument has a number of weaknesses. Integrating the separate steps of a transaction, each of which is legal, into a single and prohibited event, is common in securities regulation.¹⁷⁴ However, in these examples, the same sovereign has jurisdiction throughout the entire series of transactions, enabling it to subsequently intercede after the triggering act has occurred and view the steps retrospectively.

When a number of separate and competing state sovereigns are involved, as with section 203, the problem becomes that all the steps must be integrated for the prohibited transaction to occur, yet after the initial step, but before the prohibited step, the potential defendant has escaped the legislative jurisdiction of Delaware for the likely sanctuary of a sovereign with no interest in facilitating Delaware's extraordinary extension of its regulatory jurisdiction.

A party seeking to prevent the integrated transaction might have to litigate this claim before the initial conveyance to a foreign subsidiary.¹⁷⁵ Since no prohibited conveyance has yet occurred, a court might decide that an advisory opinion is being sought and that no controversy exists. If the challenger sought

¹⁷⁴ A series of exempt private placements may be integrated into a single nonexempt public offering.

[T]he integration doctrine . . . operates to telescope two or more transactions into one . . . [and] is the Commission's counterpart of the IRS' step-transaction analysis under which transactions which appear to be separate in form will be scrutinized closely as to substance in order to determine whether or not in fact they should be treated as two distinct transactions.

THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.12 (2d ed. 1990).

¹⁷⁵ I assume for the moment that personal jurisdiction could be obtained over the necessary parties.

an injunction on the basis that the prohibited transactions were threatened, the bidder might still prevail by showing the absence of any preliminary steps taken. Given the short lead time¹⁷⁶ necessary to accomplish the transaction, its essentially private nature, and the absence of any required notice to public stockholders of the Delaware target, the challenger would have difficulty seeking an injunction after the threat has materialized but before it has been accomplished. If the challenging party waits until the first conveyance has occurred, then effective redress may require suit in the courts of the foreign jurisdiction, hardly a sympathetic forum for a theory which seeks to justify the novel and extraordinary reach of the Delaware statute.

Moreover, Delaware adheres to the "equal dignity" doctrine,¹⁷⁷ which posits that actions taken under one provision of the statute remain lawful even though the result achieved violates some other provision. Thus, the result achieved by a transaction accomplished in two steps does not violate a provision barring the same transaction accomplished in a single step.

B. *The Due Process Constraints on Choice of Law Rules*

Due process has two elements: fairness and power.¹⁷⁸ Fairness relates to the interests of the litigants and power relates to the concerns of the sovereigns with an interest in applying their law. The concern of fairness as it relates to choice of law questions is a claim by a litigant of unfair surprise at having an unanticipated body of law applied to its litigation.¹⁷⁹ Since the preliminary transactions were devised to escape the regulatory jurisdiction of Delaware, a party whose escape is judged unsuccessful by Delaware courts could hardly claim unfair surprise.

Whether fairness as to the litigants exhausts the content of due process or whether power concerns exist independently is subject to debate. Frederic Kirgis writes:

But fairness is not its only procedural aspect, nor is due process solely a

¹⁷⁶ Transactions involving wholly owned subsidiaries could be accomplished within a matter of hours.

¹⁷⁷ *Hariton v. Arco Elecs., Inc.*, 188 A.2d 123, 125 (Del. Ch. 1963).

¹⁷⁸ See generally Frederic L. Kirgis, Jr., *The Roles of Due Process and Full Faith and Credit in Choice of Law*, 62 CORNELL L. REV. 94 (1976); James A. Martin, *A Reply to Professor Kirgis*, 62 CORNELL L. REV. 151 (1976); James A. Martin, *Constitutional Limitations on Choice of Law*, 61 CORNELL L. REV. 185 (1976); Willis L.M. Reese, *Legislative Jurisdiction*, 78 COLUM. L. REV. 1587 (1978).

¹⁷⁹ In the related area of personal jurisdiction, the objection is articulated in terms of the burden and inconvenience of defending an action in a distant forum or lack of adequate notice of the claim.

procedural doctrine. In its procedural form, the personal jurisdiction cases demonstrate that due process has a power element as well as a fairness element. Jurisdictional restrictions “are more than a guarantee of immunity from inconvenient or distant litigation. They are a consequence of territorial limitations on the power of the respective States. However minimal the burden of defending in a foreign tribunal, a defendant may not be called upon to do so unless he has had the ‘minimal contacts’ with that State that are a prerequisite to its exercise of power over him.”¹⁸⁰

James Martin, on the other hand, seeks to avoid implicating sovereign concerns in due process.¹⁸¹ He seeks to avoid a due process limitation on choice of law by arguing “that the full faith and credit clause supplies a more logical basis for limitation, since full faith and credit analysis emphasizes deference to the interests of other jurisdictions.”¹⁸² This attempt to avoid a due process constraint on choice of law must ultimately fail, because in the context of the internal affairs doctrine, the foreign state presented with a Delaware judgment purporting to regulate the internal affairs of a corporation it has created must consider whether to recognize the Delaware judgment.¹⁸³

¹⁸⁰ Kirgis, *supra* note 178, at 95–96 (quoting *Hanson v. Denckla*, 357 U.S. 235, 251 (1958)).

¹⁸¹ Martin, *A Reply to Professor Kirgis*, *supra* note 178, at 151–52; Martin, *Constitutional Limitations on Choice of Law*, *supra* note 178, at 196.

¹⁸² Martin, *A Reply to Professor Kirgis*, *supra* note 178, at 151.

¹⁸³ See generally William L. Reynolds, *The Iron Law of Full Faith and Credit*, 53 MD. L. REV. 412 (1994).

The Full Faith and Credit Clause obligates courts to recognize foreign state final judgments if the court issuing the judgment had jurisdiction. When recognition is refused because jurisdiction was lacking and inconsistent judgments result, the more recent judgment is accorded recognition by a subsequent state whether it is a third state or the original state that issued the first judgment. A court’s findings on issues of jurisdiction, once litigated, cannot usually be collaterally attacked in a second forum. Personal jurisdiction can be waived by the parties, but subject matter jurisdiction implicates interests of state sovereigns and cannot be conferred by consent.

Two intertwined questions would likely be raised by litigants seeking and opposing enforcement of § 203. The first is whether Delaware has subject matter jurisdiction over a transaction involving a foreign corporation when no formal action is required by the Delaware target and no injury or effect occurs within the jurisdictional territory of Delaware besides the refusal to comply with § 203. The second question is whether the boards of directors of the foreign corporations are necessary parties for a valid Delaware judgment ordering the Delaware target to cause the foreign subsidiaries to comply with § 203. Resolution of both questions is beyond the scope of this Article. However, if Delaware has regulatory jurisdiction because the Delaware target owns a majority of the foreign subsidiary corporations, then the state of incorporation of the interested stockholder has an equal claim to regulatory jurisdiction, because the interested stockholder’s initial tender

Ultimately, recognition must depend upon Delaware's power to adjudicate disputes involving a juridical being whose very existence depends upon the laws of another jurisdiction. This is not solely a matter of personal jurisdiction. Concededly, Delaware fortuitously might obtain personal jurisdiction over the parties (i.e., the directors of the foreign subsidiaries) as they passed through Delaware. Would this coincidence provide sufficient basis to apply its own law to the internal affairs of an entity created by another equally sovereign state?

C. Extraterritoriality

Central to the claim that Delaware lacks the power to act extraterritorially and regulate the Foreign Asset Subsidiary is the conceptually abstract notion of territory as it relates to a juridical being like a corporation. Corporations can have the usual territorial contacts with a state, as do natural persons. They also may have assets and employees located within the state's territory. When a corporation is incorporated within a state, however, it has conceptually located itself within that state's territory in a manner that has no counterpart for natural individuals. It need have no other contacts with the state, yet, in creating itself pursuant to the statute of a particular state, it is unequivocally within that state's jurisdictional territory. A natural person also may have only one domicile at a time, but a determination of the location of that domicile may be a close and difficult question. The jurisdiction of incorporation, however, is always unambiguous and free from doubt, because the very act of incorporation defines the territoriality. By availing itself of the legislative jurisdiction of a particular state through its choice of incorporation statute, it unambiguously selects its territoriality.

When, as with section 203, Delaware both relies exclusively upon the state of incorporation as sufficient regulatory nexus to regulate the Delaware target while at the same time ignores the Foreign Asset Subsidiary's jurisdiction of incorporation's regulatory sovereignty—which may have additional contacts such as location of business, assets or employees—Delaware negates the sole and abstract basis for its legislative jurisdiction. With this conceptually pure

offer makes the Delaware target its majority subsidiary. The second jurisdiction could enact an antidote provision nullifying § 203, applying the same legal principles as Delaware.

The result would be a statutory standoff between competing jurisdictions, each with equivalent claims for regulating authority. Unless a federal court decided that jurisdiction were lacking or § 203 exceeded Delaware's jurisdictional authority, each takeover adversary would race to reduce its statutory claim to final judgment, seeking to gain primacy under the Full Faith and Credit Clause. This situation of conflicting regulation fits precisely the circumstances that the dormant Commerce Clause doctrine is intended to avoid. The internal affairs doctrine, as traditionally understood, avoids this conflict.

form of territoriality, Delaware cannot have it both ways.

The concept of extraterritoriality permeates our constitutional structure, although it is never made explicit in the Constitution.¹⁸⁴ Violation of due process becomes evident when the courts of the state of incorporation of the Foreign Asset Subsidiary are presented with the judgment of a Delaware court implementing section 203.¹⁸⁵ If the Delaware court had obtained personal jurisdiction over all the relevant parties, doctrines such as collateral estoppel and *res judicata* would preclude the necessity of the second state's court reaching the constitutional issue—i.e., due process—involved in deciding whether to accord the Delaware judgment full faith and credit. But if Delaware used its conceded jurisdiction over the Delaware target to order the target's board to use its private economic power to compel the Foreign Asset Subsidiary to accede to the Delaware court's wishes, then the constitutional issues are squarely presented. The question then becomes whether the foreign state is obligated to accord full faith and credit to the Delaware judgment and the resolution of this question requires an inquiry into whether the Delaware judgment violated due process. This issue turns on whether Delaware exceeded the territorial limitations on its power.

This inquiry could consider territorial limits in a number of ways. A formal approach would consider whether the Foreign Asset Subsidiary (and its board and shareholder, the Foreign Parent Subsidiary) were necessary parties for the litigation resulting in the Delaware judgment. If they were, then the judgment could not be enforced against them. This approach fails to make explicit the issue at the heart of the matter, whether Delaware can harness the private economic power of the Delaware target board to extend its own legislative jurisdiction and territorial power. The Supreme Court has not provided analytical guidance beyond the language in *Hanson v. Denckla*,¹⁸⁶ repeated in *World-Wide Volkswagen v. Woodson*,¹⁸⁷ that due process has a power element as well as a fairness element "as a consequence of territorial limitations on the power of the respective States."¹⁸⁸ Even *Hanson's* language has been undermined somewhat by *Insurance Corp. of Ireland, Ltd. v.*

¹⁸⁴ See Regan, *supra* note 34.

¹⁸⁵ See Buxbaum, *supra* note 26, at 45–47. Buxbaum discusses the issue of full faith and credit due to judgments resulting from the race to the courthouse in the context of California's pseudo-foreign corporation doctrine, when the state choosing not to apply the internal affairs doctrine has substantial if not predominate contacts with the corporation being regulated.

¹⁸⁶ 357 U.S. 235, 251 (1958).

¹⁸⁷ 444 U.S. 286, 291–94 (1980).

¹⁸⁸ *Id.* at 294.

Compagnie des Bauxites de Guinee,¹⁸⁹ decided subsequently, when in referring to the Due Process Clause the Court said: "That Clause is the only source of the personal jurisdiction requirement and the Clause itself makes no mention of federalism concerns."¹⁹⁰ However, this dicta is distinguishable because there the Court was speaking more narrowly to the issue of personal jurisdiction and "the sovereign power of the court,"¹⁹¹ while the concern here is with legislative jurisdiction and the power of the Delaware legislature. The rationale the Court used to justify its literal reading of the Due Process Clause and the Clause's failure to mention federalism concerns does not apply to section 203. The Court's rationale, that while individual litigants can waive personal jurisdiction and because "[i]ndividual actions cannot change the powers of sovereignty,"¹⁹² there exists no interest of a sovereign, is inapplicable to the facts of section 203. The interests of a foreign sovereign are still implicated, because the Foreign Asset Subsidiary has not waived personal jurisdiction and the sovereign under which it was incorporated would have an interest in what laws apply to its internal affairs.¹⁹³

The concept of territoriality embedded in the internal affairs doctrine, while abstract, is more "real" than the territoriality of land itself. Land is not always unambiguously or permanently located in a particular state. When rivers form boundaries between states, a shift in the river bed can result in a change of the land from one state to another. The land's state of sovereignty and governing law has changed. Land in some states can only be privately owned above the high tide mark. Thus, private land can be eroded away and can disappear. The concept of territoriality implicit in the internal affairs doctrine, however, always produces a clear and unambiguous result for a state within which the corporation is located. The territoriality is tautological.

Within our federal system, Delaware's deliberate usurpation of the internal governance of corporations chartered by sister states can neither be ignored nor can an asymmetrical balance be struck with Delaware by fiat establishing its juridical primacy as first among equals. Our federal system requires that this conflict between coequal subordinate sovereigns be resolved under the federal Constitution, so that one of the competing legal rules is invalidated.

This same conflict often appears in the international arena, but in the

¹⁸⁹ 456 U.S. 694 (1982).

¹⁹⁰ *Id.* at 703 n.10.

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ This interest could be either abstract and formal or exceedingly practical. If the internal affairs doctrine could so easily be supplanted, then Delaware, which depends on corporate franchise taxes for a major share of state revenues, would risk serious financial interests.

absence of a supreme world government to resolve it, it festers, creating tensions that provoke retaliation and even escalation. The resolution of equivalent tensions by a supreme federal government is critical for our national unity.

1. *Extraterritoriality in the International Context*

Extraterritoriality in the international context is of two types: home country, in which the jurisdiction of the parent company seeks to impose its substantive law on a foreign subsidiary; and host country, in which the jurisdiction of the subsidiary corporation seeks to impose its substantive law on the parent firm.¹⁹⁴ In either case, conflicts often arise between the domestic and foreign jurisdictions. To avoid these conflicts, international law developed the *nationality principle*, which, much like the internal affairs doctrine, looks to the state of incorporation to determine which nation can apply its substantive laws. Under this principle, a foreign corporation does not acquire the nationality of either its parent or its own foreign subsidiary.

The *territorial principle* and its corollary, the “*effects doctrine*” are also consensus rules for extraterritorial application of laws. These two principles provide that a state has power to regulate conduct either by corporations incorporated under its laws, conduct within its territory, or conduct taking place outside its territory but with substantial effects within its territory.

U.S. law, much like Delaware’s section 203, has used the fact of private economic power or practical control over foreign subsidiaries to aggressively move beyond both principles to assert extraterritorial regulatory power in trade, antitrust, securities, and tax contexts, while at the same time it has resisted reciprocal application.¹⁹⁵ Some countries have enacted “blocking statutes”¹⁹⁶ forbidding their domestic corporations from conforming their conduct to U.S. regulatory requirements.¹⁹⁷ Others have responded with turn about being fair play. Canada has asserted application of its Foreign Investment Review Act to a Delaware merger between two Delaware corporations because one company had a Canadian subsidiary. The U.S. has protested this extraterritorial application of Canadian law.¹⁹⁸

These conflicts and one-sided (and unfair) assertions of extraterritoriality

¹⁹⁴ See generally PHILLIP I. BLUMBERG, *THE MULTINATIONAL CHALLENGE TO CORPORATION LAW* 168–201 (1993).

¹⁹⁵ *Id.* at 195.

¹⁹⁶ These are analogous to the “antidote” statutes that could neutralize § 203. For further explanation, see *supra* text in paragraph following note 107.

¹⁹⁷ BLUMBERG, *supra* note 194, at 194 (citation omitted).

¹⁹⁸ *Id.* at 195.

may be tolerable in the international arena in which recourse to war is a recognized remedy. Without a supreme sovereign to mediate these conflicts and mandate consistent standards, brute force becomes the governing principle by default. It is precisely to avoid this situation that under our system state sovereigns are subordinated to a federal sovereign whose hegemony denies power to the states to extraterritorially infringe on another state's sovereignty and undermine national unity.¹⁹⁹

The domestic equivalent of the effects doctrine mutes and resolves similar conflicts in the American federal system. It is this doctrine that permits the assertion of regulatory jurisdiction over foreign subsidiaries in the familiar context of self-dealing transactions, without such an assertion of power being extraterritorial.

2. Practical Power (Private Economic Power) and Self-Dealing

To describe the reach of section 203 as extraterritorial means that its reach possesses two characteristics, and constitutional invalidity requires the presence of both. The first characteristic is the use of "practical power" to effectuate section 203's prohibition instead of a prohibition of a formal corporate action imposed on the Delaware target corporation. The second is the absence of any harm or injury within Delaware's territorial jurisdiction except the thwarting of section 203's prohibition. The absence of injury distinguishes the reach of section 203 from long-standing prohibitions of unquestioned validity against self-dealing or other transactions involving foreign subsidiaries which injure the corporate parent or subsidiary.

Section 203 attempts to regulate the prohibited transaction through practical power, because even though the Delaware target has undoubted control over the Foreign Asset Subsidiary, to accomplish the prohibited business combination requires no formal corporate action by the Delaware target corporation. Practical power or control reflects private economic power and does not threaten a foreign sovereign precisely because it is private and can make no claim to equal status with that sovereign. It depends upon the

¹⁹⁹ LEA BRILMAYER, *CONFLICT OF LAWS* 113 (1991). Brilmayer argues:

Federalism is what makes constitutional limits on state authority necessary, for if the nation were not divided into separate states there would be no need to determine the legitimate reach of state authority. It is also what makes constitutional limits possible, for if there were no federal government the states would be more or less free to do as they wish.

Id.

sovereign state for its legitimacy. One of the fundamental purposes of our government is the preservation and protection of private property. Another state sovereign cannot even exclude a foreign corporation from its jurisdiction, since to do so would discriminate against interstate commerce. However, Delaware's appropriation of this private power to extend its own regulatory jurisdiction is an invasive act, the equivalent of a Trojan horse inserted within the walls of a foreign sovereign's territory.

To permit such an appropriation, to permit Delaware to command for its own ends the private market and economic power of its corporate citizens and include within its regulatory jurisdiction everything over which its citizens have practical control would create an imperial state that would undermine a harmonious system of coequal sovereign states.

Of course section 203 has no such imperial intentions on its face. It appears innocuous. But it contains no limiting factors that acknowledge territorial limits on Delaware's power. It acknowledges no jurisdictional limits and prohibits transactions without regard to harmful effect or injury within Delaware. Potentially, the same justification could command that all its Delaware corporate citizens have the private, practical power to command by virtue of majority ownership of foreign subsidiaries. It could prohibit the interested stockholder from changing the directors or officers of any majority owned foreign subsidiary of a Delaware corporation. Or it could mandate that after a change of control transaction the directors of any majority owned subsidiary, domestic or foreign, could be removed only for cause and would serve for an additional three year term. It could also require that all choice of law provisions in contracts entered into by such foreign subsidiaries, which are outside the internal affairs doctrine, explicitly chose Delaware law as the governing law. It could use the same triggering event of a hostile change of control and forbid all plant relocations or closings by any domestic or foreign majority owned subsidiary of a Delaware corporation whether within a state or between states.²⁰⁰ It could transform the private decision making power of its corporate citizens into Delaware law by mandating that its corporate citizens adhere to Delaware's substantive environmental, tort, contract, and property law in all their dealings throughout the world.

Most corporate lawyers operate on the sound assumption that fiduciaries cannot escape state conflict of interest regulation or prohibition of injurious self-dealing transactions simply by accomplishing the transactions through the clever use of practical or private power over foreign subsidiaries. But these transactions, unlike section 203's business combinations, injure the domestic

²⁰⁰ Because this prohibition would apply regardless of the state of existing plant location, Delaware could even argue that this does not discriminate against interstate commerce although its burden might outweigh its benefits.

parent firm. The injury occurs within the physical or conceptual territory of the state of the Delaware parent firm. This connection serves as a familiar and legitimate basis for regulatory jurisdiction, both in the international context (the effects doctrine) as well as in our federal system. If there is injury or unfairness, the court can set the transaction aside or provide other relief. However, if there is no injury, and the transaction is fair to the parent firm, then the court has no basis or justification to set it aside or otherwise interfere. Without injury or the need for formal corporate action by the domestic parent firm, the court would also lack power to interfere or assert extraterritorial regulatory jurisdiction over a foreign subsidiary.

Concededly, the Foreign Asset Subsidiary's asset sales to the interested stockholder or its statutory merger with the interested stockholder's acquisition subsidiary would be self-interested transactions under judicially created doctrine.²⁰¹ They could be set aside if injurious or unfair. However, conflict of interest prohibitions do not violate the internal affairs doctrine or operate extraterritorially to subvert the federal system like section 203 because of a critical distinction involving fiduciary duties.

Fiduciary obligations imposed by Delaware prevent Delaware target directors from acting unfairly to minority shareholders under conflict of interest prohibitions. Even though accomplishing the unfair transaction requires no formal corporate action by the Delaware target, the fiduciary duty that Delaware law imposes on the directors of the Delaware target charges them with an affirmative duty not to permit subordinates in subsidiaries over which they exercise actual practical control to act in a manner injurious to the beneficiaries of their fiduciary obligations. If there is unfairness to the minority shareholders or to the target corporation, then there is injury (an effect) within the territory of Delaware sufficient to sustain its regulatory jurisdiction within the traditional constraints of federalism.

Section 203, in contrast, requires directors to use their private power, their practical control, to prevent²⁰² the disposition of assets held by foreign subsidiaries even if done fairly so that no injury or effect exists within Delaware territory. This requirement operates extraterritorially, because Delaware uses the directors' practical control, created by mere ownership of a property interest created and sustained by a foreign jurisdiction, to extend its regulatory power into that foreign jurisdiction. This goes beyond the constraints of federalism, and in doing so, it exceeds the constitutionally

²⁰¹ See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. Super. Ct. 1983); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

²⁰² In the hypothetical transactions illustrated in Figures 1 and 2, no formal action by the Delaware target board is required to authorize the sale or merger by the Foreign Asset Subsidiary.

permissible limits.²⁰³

The absence of any effect or injury within Delaware's conceptual territory is evident from the explicit recognition²⁰⁴ that business combinations are not barred if they were approved by the board of the Delaware target prior to the date the interested stockholder acquires shares in the target and thereby becomes an interested stockholder.²⁰⁵ The quality or fairness of the transaction is irrelevant. The critical determinate is the time of approval.

If Delaware attempted to sustain its jurisdiction premised on the statute's treating business combinations as conclusively presumed to cause injury to the Delaware target, the other provisions of the statute undermine this position. Ordinary self-dealing creates only a rebuttable presumption of injury and Delaware General Corporation Law section 144 provides special board and shareholder voting procedures to rebut this presumption. If a hostile bidder acquired all but a single share of the target and then engaged in an unfair self-dealing transaction, the owner of the single share could enjoin the unfair transaction.²⁰⁶ Yet section 203 provides an exemption from its application if the bidder acquires at least eighty-five percent of the target.²⁰⁷ It makes no sense to conclusively presume injury because of a business combination, and yet permit the injury to be sustained by up to fifteen percent of the shareholders, while creating only a rebuttable presumption for ordinary self-dealing, when a single share can prevent an unfair transaction. Section 203 is not designed to prevent shareholder injury. It is intended to provide a defense for incumbent management. This is a permissible objective for Delaware, but it cannot be achieved through extraterritorial regulation of a foreign subsidiary.

D. *Equal Protection Constraints on Choice of Law*

The highly specific circumstances under which Delaware abrogates the

²⁰³ See generally Regan, *supra* note 34.

²⁰⁴ DEL. CODE ANN. tit. 8, § 203(a). If business combinations injured the Delaware target, they could be barred or set aside on this ground, making the antitakeover statute unnecessary.

²⁰⁵ *Id.* Otherwise prohibited business combinations also can be consummated if the board of the target gives approval prior to the transaction by which the interested stockholder becomes an interested stockholder. *Id.*

²⁰⁶ This assumes no disinterested directors and no other disinterested shareholders. Title 8, § 144(a)(2) of the Delaware Code appears to permit approval by all shareholders, but *Marciano v. Nakash*, 535 A.2d 400, 403-04 (Del. 1987), in dicta interprets this provision to require a disinterested shareholder vote. The requirement of a disinterested shareholder vote is the same adopted by the Revised Model Business Corporation Act. MODEL BUSINESS CORP. ACT § 8.63 (1984).

²⁰⁷ DEL. CODE ANN. tit. 8, § 203(a)(2).

internal affairs doctrine with section 203 suggests a basis for a viable equal protection challenge to this statute, despite the absence of classifications or interests justifying a level of equal protection analysis stricter than rational basis scrutiny. Equal protection challenges subjected to rational basis scrutiny have rarely succeeded, but in this instance, section 203 combines an unusually arbitrary basis of classification with an aspect of interstate commerce, namely, section 203's application to the Delaware target's foreign subsidiaries. Because such a combination has generated one of the few bodies of Supreme Court decisions invalidating equal protection classifications subjected to rational basis scrutiny,²⁰⁸ it provides a critical vulnerability.

Section 203's application to foreign subsidiaries can be characterized as using fatally arbitrary classifications for two reasons. First, it abrogates the internal affairs doctrine only in a peculiar set of circumstances, which lacks any principled basis (or any articulated basis at all) for classifying foreign corporations into those to which the internal affairs doctrine will apply and those to which it will not. Second, Delaware would not recognize such an abrogation on a reciprocal basis when applied by a sister state to a Delaware corporation.²⁰⁹

The peculiar set of circumstances exists when a hostile bidder in the guise of a foreign corporation forms a wholly owned foreign acquisition subsidiary which it uses to acquire majority control of the Delaware target. After the preliminary conveyances described in Part III, Figure 1, the Delaware target (now the majority owned subsidiary of the foreign acquisition subsidiary) wholly owns the Foreign Parent Subsidiary which in turn wholly owns the Foreign Asset Subsidiary. The Foreign Asset Subsidiary owns the assets which section 203 bars from conveying to the interested stockholder in a prohibited business combination. Delaware strictly adheres to the internal affairs doctrine and has described it as being of almost constitutional significance.²¹⁰ Yet if section 203 is to be effective, it must apply Delaware law to control the internal affairs of the Foreign Asset Subsidiary in order to bar the prohibited business combination. However, Delaware has not explicitly articulated any basis to deviate from this strongly held doctrine that would bar such a transaction.

Moreover, Delaware must justify deviation from the internal affairs

²⁰⁸ See *Attorney General of New York v. Soto-Lopez*, 476 U.S. 898 (1986); *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985); *Hooper v. Bernalillo County Assessor*, 472 U.S. 612 (1985); *Williams v. Vermont*, 472 U.S. 14 (1985); *Zobel v. Williams*, 457 U.S. 55 (1982).

²⁰⁹ This rather bald assertion about Delaware's future actions is premised upon Delaware's strong adherence to the internal affairs doctrine and its jealous concern for Delaware corporations as a source of franchise tax revenue.

²¹⁰ See *McDermott Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987).

doctrine and apply section 203 to the Foreign Asset Subsidiary on some basis which would not also justify the ouster of Delaware law from the internal affairs of the Delaware target. Both the Delaware target and the Foreign Asset Subsidiary are subsidiaries owned by foreign parent corporations in a multi-tiered chain of subsidiary holdings. Stock ownership by the Delaware target cannot provide a basis to apply Delaware law to the internal affairs of the Foreign Asset Subsidiary, because the stock of the Delaware target is itself owned by the foreign acquisition vehicle. Such a justification would go too far. It would also justify supplanting Delaware law for the internal affairs of the Delaware target—now a subsidiary of the acquisition subsidiary—which from the Delaware perspective would create an unacceptable result.

On its face, section 203 does not classify corporations into foreign and domestic corporations, nor does it treat them differently. However, by applying section 203 to the Foreign Asset Subsidiary and prohibiting business combinations with the interested stockholder, Delaware does implicitly classify foreign corporations into two groups, those whose internal affairs are governed by their state of incorporation and those whose internal affairs are governed by the laws of some other state. This classification of foreign corporations and the differing treatment accorded them involves neither suspect classes nor fundamental interests, so the level of equal protection scrutiny deemed appropriate by the Court is the minimal rational basis level of scrutiny. Such a classification discriminates against interstate commerce and is invalid because it does not advance a legitimate state purpose.²¹¹

In *Ward*,²¹² the Court considered whether Alabama's discriminatory tax against foreign corporations bore a rational relationship to a legitimate state purpose sufficient to avoid a violation of the Equal Protection Clause. An equally divided Court held that "promotion of domestic business by discriminating against nonresident competitors is not a legitimate state purpose."²¹³ Despite this minimal level of scrutiny, Delaware's purpose in implicitly adopting its classification of foreign corporations is to prevent their escape from the legislative jurisdiction of Delaware. It attempts to prevent their escape by discriminating against foreign subsidiaries and deviating from the internal affairs doctrine. This is not a legitimate state purpose sufficient to validate the classifications when confronted with an equal protection challenge.

²¹¹ See *supra* part V for a Commerce Clause analysis of state statutes that discriminate against interstate commerce. In distinguishing Commerce Clause from equal protection analysis, the *Ward* Court wrote, "one protects interstate commerce, and the other protects persons from unconstitutional discrimination by the States." *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985) (citations omitted).

²¹² *Id.*

²¹³ *Id.* at 882.

A separate basis to condemn Delaware's section 203 as an arbitrary classification that is incapable of surviving minimal rational basis scrutiny derives from Delaware's strict adherence to the internal affairs doctrine.²¹⁴ Failure to accord a sister state the same recognition of its domestic law as that demanded by Delaware of other states is necessarily arbitrary in an equal protection sense.²¹⁵ Equal protection does not require complete symmetry, but it should require at least the possibility of reciprocity. I have found no Delaware decisions recognizing the ouster of Delaware law from governing the internal affairs of a Delaware corporation. Even more unlikely would be Delaware's recognition of such an ouster justified only by stock ownership by a foreign parent. The Delaware Supreme Court has recently held that for choice of law purposes stock ownership is "no contact" at all.²¹⁶

Despite its status as the leading state of incorporation, Delaware cannot protect this valuable position by unilaterally mandating its hegemony over sister states. Such hegemony would fail to comport with a federal system of coequal state sovereigns.

VI. CONCLUSION

Third generation business combination antitakeover statutes superficially appear consistent with the internal affairs doctrine. They do not explicitly apply to foreign corporations, and have therefore been uniformly upheld against constitutional challenges premised upon the dormant Commerce Clause. However, to accomplish their objective of inhibiting leveraged takeovers by preventing the sale of assets to pay off acquisition debt, they must and do apply to subsidiaries of the target corporation. Since these subsidiaries can be created as foreign subsidiaries, the application of these statutes violate the internal affairs doctrine, the uniform choice of law doctrine of the enacting states.

²¹⁴ See *Draper v. Gardner Defined Plan Trust*, 625 A.2d 859 (Del. 1993).

²¹⁵ Cf. *Ward*, 470 U.S. at 877-78, in which an equally divided Court in discussing earlier authority gave credence to the relevance of reciprocity by recognizing that California had a legitimate state purpose in enacting a retaliatory tax to promote the interstate business of domestic insurers by deterring other states from enacting discriminatory taxes, but that Alabama had no legitimate purpose in promoting domestic business by discriminating against nonresident competitors.

²¹⁶ See *McDermott Inc. v. Lewis*, 531 A.2d 206, 214 n.6 (Del. 1987) (holding that stock ownership amounted to "no contact whatever with Delaware"). In *McDermott*, a Panamanian corporation owned 92% of a Delaware subsidiary which in turn owned 10% of its Panamanian parent. The issue before the court was whether the subsidiary could vote its stock in its parent, something permissible under Panamanian law but impermissible in any U.S. jurisdiction. Under the internal affairs doctrine the voting rights of shares in a Panamanian corporation were held to be determined solely by the law of Panama.

Delaware has a strong interest in maintaining the integrity of traditional internal affairs doctrine because it, among all states, probably has the fewest significant contacts (for choice of law purposes) with the corporations it charters. In section 203, Delaware has inadvertently departed from the internal affairs doctrine as its basis for choice of law. In doing so, it has exposed its sizeable investment in its own corporation law to the risk of being ousted from the governance of the corporations it charters by the laws of other states with more significant contacts with these Delaware-chartered corporations.

Section 203 purports to govern foreign subsidiaries even if they have no contacts at all with Delaware. The only nexus Delaware has with the foreign subsidiary is indirectly through its shareholder. Such a drastic choice of law rule creates severe constitutional difficulties, not only under the dormant Commerce Clause concern for inconsistent regulation, but under the Full Faith and Credit, Due Process, and Equal Protection Clauses as well.²¹⁷ The danger of inconsistent regulation alone led the Supreme Court to invalidate the Illinois statute in *MITE*. The Delaware statute's infirmities far exceed those in *MITE*. Attempting to salvage these statutes by limiting their application to domestic subsidiaries would produce only a pyrrhic victory. Such a limitation would merely create an enormous loophole.²¹⁸ The only sensible course is to clarify the law by constitutionalizing the internal affairs doctrine as *CTS* strongly implied.

²¹⁷ See Kozyris, *supra* note 33; Stanley A. Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1968).

²¹⁸ If applied only to domestic subsidiaries, then the effect of these statutes could be avoided by arranging for the prohibited transactions to take place with foreign subsidiaries.