PSEUDO-FOREIGN CORPORATIONS AND THE "INTERNAL AFFAIRS" RULE

IN *Mansfield Hardwood Lumber Co. v. Johnson*,[1] the minority shareholders of a family corporation that was doing business in Louisiana but had been incorporated in Delaware, sued the corporation in a Louisiana federal district court to rescind a sale of stock they had made to the corporation. The plaintiffs alleged that the officers, who were also the majority shareholders, had conspired to purchase the outstanding minority shares at a low price and then liquidate the corporate assets for a large profit.[2] The district court found for the plaintiffs, apparently applying Louisiana law as a matter of course. The Court of Appeals for the Fifth Circuit affirmed. On petition for rehearing, the defendants argued the widely accepted rule that, when the issue involves the "internal affairs" of a foreign corporation, the law of the state of incorporation should be applied.[3] If the court had applied Delaware law, the plaintiffs probably would have been denied relief, because, as the court indicated, Delaware law does not impose a fiduciary duty upon the officers of a corporation when they are purchasing stock from minority shareholders for the corporation.[4] Faced with this choice-of-law question, the court rejected the rule that the law of the state of incorporation

[1] 268 F.2d 317 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959). The instant case denied a re-hearing of the prior determination on the merits. 263 F.2d 748 (5th Cir. 1959).

[2] Plaintiffs claimed at least $3,300,000 damages. Brief for Appellee, p. 5, Mansfield Hardwood Lumber Co. v. Johnson, 242 F.2d 45 (5th Cir. 1957).

[3] See Williams v. Green Bay & W.R.R., 326 U.S. 549 (1946), where the Supreme Court reversed the holding of a district court that had refused jurisdiction of "internal affairs," and at the same time called for the application of the law of the state of incorporation. See also, RESTATEMENT, CONFLICTS § 197 (1934); Latty, *Pseudo-foreign Corporations*, 65 YALE L.J. 137, 138-43 (1955).

[4] "Apparently, Delaware imposes no fiduciary duty on the part of the officers or directors or majority stockholders in buying stock from the minority or individual stockholders." 268 F.2d at 320, citing Cahall v. Loffland, 12 Del. Ch. 299, 114 Atl. 224 (Ch. 1921). *But see*, Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939) (officers and directors stand in a fiduciary relation to the stockholders). In Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947), the court stated: "The majority has a right to control, but when it does so it occupies a fiduciary relation toward the minority . . . ." See also, Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), and cases cited therein. Under these cases, it is arguable that application of Delaware law would have produced the same result.

governs the internal affairs of a foreign corporation and upheld the district court's application of Louisiana law.

The *Mansfield* case thus raises the recurring problem whether the law of the forum or that of the state of incorporation is applicable to a pseudo-foreign corporation. Early decisions took the position that local courts lacked jurisdiction to adjudicate disputes which concerned the "internal affairs" of a foreign corporation.[5] This approach has been side-stepped by one technique or another, so that this rule presently amounts to little more than one of *forum-non-conveniens*.[6] This is particularly true where the corporation is predominantly local. Although courts now take jurisdiction of cases involving "internal affairs" of foreign corporations, the choice-of-law rule requires that the law of the state of incorporation be applied.[7] Evolution comparable to that in the jurisdictional problem can be expected in the choice-of-law issue. Apparently, this evolution has begun, although courts which have chosen to apply local law to pseudo-foreign corporations still pay lip service to the general rule while circumventing it by concluding that the particular issue does not involve an "internal affair."[8]

In the *Mansfield* case, however, the court's decision to apply the law of Louisiana was not reached by a manipulation of the "internal affairs" label. Referring to cases holding that the law of the state of incorporation is applicable to "internal affairs," the court said:[9]

[5] See 17 FLETCHER, PRIVATE CORPORATIONS § 8425 (perm. ed. 1933); 20 C.J.S. *Corporations* § 1879 (1940).

[6] See Note, *The "Internal Affairs" Doctrine in State Courts*, 97 U. PA. L. REV. 666 (1949).

N.C. GEN. STAT. § 55-133(a) (Supp. 1959) provides: "No action in the courts of this State shall be dismissed solely on the ground that it involves the internal affairs of a foreign corporation but the court may in its discretion dismiss such an action if it appears that more adequate relief can be granted or that the convenience of the parties would be better served by an action brought in the jurisdiction of its incorporation or in the jurisdiction where the corporation has its executive or managerial headquarters or, because of the circumstances in some other jurisdiction."

[7] See note 3 *supra*.

[8] See Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. 1953) (suit by stockholder for an injunction preventing the remaining stockholders from conducting a directors' meeting was held to involve the individual stockholders, not the "internal affairs" of the corporation); Loan Soc'y of Philadelphia v. Eavenson, 241 Pa. 65, 88 Atl. 295 (1913) (suit by a corporation against former officers and directors to recover losses sustained due to their negligence did not involve "internal affairs"). *But see*, Rosenfield v. Roebling Coal Co., 124 N.J. Eq. 348, 5 A.2d 695 (Ch. 1939) (stockholders' suit against a corporation based on alleged misappropriation and waste of funds by officers and directors did involve "internal affairs"). See also, Annot., 155 A.L.R. 1231 (1945); Note, 46 COLUM. L. REV. 413 (1946).

[9] 268 F.2d at 321.

Those decisions are, however, in our opinion, either inapplicable or unsound where the only contact point with the incorporating state is the naked fact of incorporation and where all other contact points, such as residence of parties and actors, situs of property, lex loci delecti or contractus, place where corporation is conducting its only or principal place of business, et cetera, are found in another jurisdiction. Certainly, in such a situation the charter of the corporation and even nonrepugnant statutory laws of the state of incorporation limiting corporate powers should govern the internal affairs of the corporation. When, however, the situation is such as here, where neither the charter nor the statutory laws of the incorporation state are applicable, and *all* contact points are in the forum, we believe that the laws of the forum should govern.

According to this approach, even an extremely "local" foreign corporation should, in some matters, be governed by the law of the state of incorporation. The court in *Mansfield* noted this when it observed that the charter and nonrepugnant regulatory statutes of the incorporating state should govern in certain matters. A court should, for example, apply the incorporating state's law to such questions as whether the corporation has the requisite number of incorporators,[10] whether all the corporate powers must be explicitly stated in the charter,[11] and whether stockholders pre-emptive rights must be expressly provided for in the charter.[12]

Where, however, the corporation's only contact with the incorporating state is the fact of incorporation, and where all other contact points, such as residence of parties and place of business, are within the forum, local law should supplant foreign law. The court declared that those decisions which applied the law of the state of incorporation when the question involved "internal affairs," were unsound or inapplicable. Perhaps such a clear-cut case will arise only rarely because the activities of few pseudo-foreign corporations occur solely within the forum. Moreover, this was not the situation in the *Mansfield* case. Besides its activities in Louisiana, the corporation owned a small railroad and substantial timber in Arkansas,[13] as well as a retail system in Arkansas and Texas.[14]

[10] IOWA CODE ANN. § 491.2 (1949), permits incorporation by a single person. The usual statute requires three incorporators. DEL. CODE ANN. tit. 8, § 101 (1953).

[11] DEL. CODE ANN. tit. 8, § 121 (1953), allows the corporation to exercise only those few powers enumerated in the statute, plus the powers expressly given in its charter, while NEV. REV. STAT. § 78.035 (1957), provides that the corporation may have any lawful power unless expressly limited by the certificate of incorporation.

[12] CAL. CORP. CODE § 1106, requires that pre-emptive rights be expressly provided, while OHIO REV. CODE ANN. § 1701.40 (Page 1954), provides for pre-emptive rights unless expressly excluded in the articles of incorporation.

[13] Brief for Appellee, p. 9. [14] *Ibid.*

Furthermore some of the plaintiff-stockholders were citizens of Arkansas.[15] It is clear from these facts that the "all contacts" requirement was not met in this case. It must be noted, however, that many activities of the corporation were carried on in Louisiana, and several of the parties to the action were Louisiana residents. Thus, the court probably had in mind a test based only upon dominant contacts with the forum state.

In any event, the court overlooked the fact that the corporation conducted activities outside the forum, applied its "all contacts" test, and held that Louisiana law was applicable. By apparently grounding its decision to apply local law on an erroneous assumption of fact, the court found it unnecessary to express the underlying policy reasons governing its choice of applicable law.[16]

The policy considerations which justify such a result have, however, been articulated in several comparable cases. An Oklahoma court, after describing a Delaware corporation as "tramp" or "migratory," held that a local statute giving stockholders the right to inspect corporate books was applicable to that corporation.[17] The court rationalized that the corporation was not, strictly speaking, "a foreign corporation with respect to the examination and inspection of its books and records by stockholders."[18] This language clearly reflects the court's prior conclusion that local law should have been applied to that controversy. The reason for a similar prior conclusion was spelled out by the Supreme Court of Iowa as a "consideration of public policy, convenience, expedience and justice."[19] Only rarely do courts allude to these factors. Usually, the underlying reasons for applying local law are obscured by manipulation of the "internal affairs" label. Nevertheless, the policy factors which have led to such manipulation have remained constant.[20]

[15] *Id.* at 5.

[16] Cases applying local law have been categorized as: cases turning on situs of shares of stock sought to be garnisheed for debt, Wait v. Kern River Mining, Milling & Dev. Co., 157 Cal. 16, 106 Pac. 98 (1909), and cases finding the law of the incorporating state contrary to local policy, Hill v. Beach, 12 N.J. Eq. 31 (Ch. 1858); Empire Mills v. Allston Grocery Co., 15 S.W. 200 (Tex. Ct. App. 1891). See Latty, *supra* note 3, at 150-55.

[17] Toklan Royalty Corp. v. Tiffany, 193 Okla. 120, 122, 141 P.2d 571, 573 (1943).

[18] *Ibid.*

[19] State *ex rel.* Weede v. Iowa So. Util. Co., 231 Iowa 784, 818, 2 N.W.2d 372, 395 (1942). Although these words were said with reference to accepting jurisdiction, the court implied that the same considerations would be applicable to choice of law. *Id.* at 808, 2 N.W.2d at 386.

[20] See Latty, *supra* note 3.

Perhaps the *Mansfield* decision supports Professor Currie's suggested approach to the entire conflict-of-laws problem. He proposes that:[21]

1. Normally, even in cases involving foreign factors, a court should, as a matter of course, look to the law of the forum as the source of the rule of decision.
2. When it is suggested that the law of a foreign state, rather than the law of the forum should furnish the rule of decision, the court should first of all determine the governmental policy—perhaps it is helpful to say the social, economic or administrative policy—which is expressed by the law of the forum. The court should then inquire whether the relationship of the forum state to the case at bar—that is, to the parties, to the transaction, to the subject matter, to the litigation—is such as to bring the case within the scope of the state's governmental concern, and to provide a legitimate basis for the assertion that the state has an interest in the application of its policy in this instance.

Under this proposal, the applicability of local law would be determined by the importance of the local policy embodied in the rule and on the extent of local contact with the controversy.[22]

In the *Mansfield* case, the Louisiana rule that the officer-shareholders act in a fiduciary capacity when purchasing stock from minority shareholders[23] rests on compelling policy considerations: Officers and majority

[21] Currie, *The Constitution and the Choice of Law: Governmental Interests and the Judicial Function*, 26 U. CHI. L. REV. 9-10 (1958). See also, Kramer, *Interests and Policy Clashes in Conflict of Laws*, 13 Rutgers L. Rev. 523 (1959), for an excellent discussion of Professor Currie's theory.

[22] The application of this test does not appear to raise any constitutional problems. The Supreme Court, in Hoopeston Canning Co. v. Cullen, 318 U.S. 313 (1943), upheld the New York requirement of a standard insurance contract to be used within that state despite an objection that this requirement violated the due process clause of the fourteenth amendment. The Court reasoned that: "To insure the protection of state interests it is now recognized that a state may not be required to enforce in its own courts the terms of an insurance policy normally subject to the law of another state where such enforcement will conflict with the public policy of the state of the forum." *Id.* at 316-17. Similarly, the Court has applied the "interest" test in upholding a Louisiana statute allowing direct action against insurance companies that issue policies contracting to pay liabilities imposed upon their insured.

In answering the contention that such a statute violated the full faith and credit clause of the fourteenth amendment, the Supreme Court weighed the interests of the states involved and concluded that Louisiana's interest was the greater. "Since this is true, the Full Faith and Credit Clause does not compel Louisiana to subordinate its direct action provisions to Massachusetts contract rules." Watson v. Employers Liab. Assur. Corp., 348 U.S. 66, 73 (1954). See Currie, *supra* note 21; Latty, *supra* note 3, at 162-66.

[23] "Louisiana has long recognized the fiduciary relationship in situations like the present case . . . ." 268 F.2d at 319.

shareholders should not be permitted to utilize their positions to enrich themselves at the expense of the minority shareholders; minority shareholders must be able to invest in corporate securities in order to receive a fair return on their capital;[24] an expanding economy requires the capital and hence the confidence of minority shareholders.[25] The Louisiana rule evidences a conviction that the minority shareholder must be adequately protected, and that the fiduciary concept helps provide this protection.

Keeping these policy considerations in mind, it is necessary to determine whether the corporation's contacts with Louisiana were sufficient to establish that state's interest in applying its own law. Mansfield's contacts with Louisiana were well-established. Its principal office was located in the state, and it owned two lumber mills there.[26] Most of the negotiation leading to the sale of the plaintiffs' stock also occurred within the state.[27] Moreover, several Louisiana citizens were almost wholly dependent on income from the minority shares of the corporation.[28] Thus, it seems obvious that the corporation had sufficient contacts with the forum to justify application of local law.

Weighing Delaware's interest in having its law applied to the case, it is apparent that Mansfield was the typical Delaware corporation, incorporated there to do virtually all its business elsewhere. Thus, Mansfield's contacts with Delaware were negligible. The argument that uniformity of decision can be achieved only if Delaware law is applied is not convincing, since there is little likelihood of inconsistency of decision here. While it can be argued that, by holding Mansfield stock, the shareholders agreed to be bound by Delaware law, the validity of such an assertion is, at best, questionable.[29]

Thus, Louisiana's interest in applying its law to the controversy clearly predominates over considerations that might warrant application

[24] Lattin, *The Minority Stockholder and Intra-Corporate Conflict*, 17 IOWA L. REV. 313, 315 (1932).

[25] Lattin, *Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders*, 30 MICH. L. REV. 645, 660 (1932).

[26] Brief for Appellee, p. 9.

[27] *Id.* at 17.

[28] *Id.* at 15-16.

[29] This is particularly true in this case because the corporation had originally been incorporated in Arkansas, but had moved to Delaware in 1940. *Id.* 5-6. Because the minority stockholders were in no position to prevent this move, it cannot be argued that they "agreed" to be bound by Delaware law, especially since such a forced "agreement" would work such a hardship.

of Delaware law. While the *Mansfield* decision does not discuss these policy factors, it is believed that similar considerations contributed to the outcome. The *Mansfield* approach, abandoning as it does the traditional "internal affairs" concept, should contribute to a more sensible solution of the problem of which law is applicable to a pseudo-foreign corporation.