Choice of Law in Veil Piercing Litigation: Why Courts Should Discard the Internal Affairs Rule and Embrace General Choice of Law Principles

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INTRODUCTION

If a corporate creditor seeks to "pierce the corporate veil" of the debtor corporation to hold a particular shareholder personally liable for the corporation's unsatisfied obligations to that creditor,
what law should be applied to resolve the matter? In particular, should the law of the state of incorporation be applied, under the theory that the crucial relationship involved in such a controversy is the one between the corporation and the target shareholder, an "internal" relationship that, under the widely respected internal affairs doctrine, is properly governed by that state's law? Or should the courts instead regard the crucial relationship involved as being the one between the creditor and the corporation, and consequently utilize general choice-of-law principles, which call for balancing the interests of all jurisdictions that have relevant contacts with the matter or with the creditor or corporation, to determine which state's law to apply?

2. See infra text accompanying notes 32–37.

3. The Restatement (Second) of Conflict of Laws (1969) [hereinafter Restatement (Second)] articulates the general choice-of-law framework for both tort and contract claims and treats these different types of claims somewhat differently. The most important of these provisions are set forth below. The general choice-of-law framework for determining the law applicable to tort claims is contained in Restatement (Second) section 145:

(1) The rights and liabilities of the parties with respect to an issue in tort are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the occurrence and the parties under the principles stated in § 6.

(2) Contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include: (a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicil, residence, nationality, place of incorporation and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered. These contacts are to be evaluated according to their relative importance with respect to the particular issue.

Restatement (Second) section 6, which is referred to above by section 145(1), states the following:

(1) A court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law.

(2) When there is no such directive, the factors relevant to the choice of the applicable rule of law include (a) the needs of the interstate and international systems, (b) the relevant policies of the forum, (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue, (d) the protection of justified expectations, (e) the basic policies underlying the particular field of law, (f) certainty, predictability and uniformity of result, and (g) ease in the determination and application of the law to be applied.

For contract claims, the Restatement (Second) states at section 186 that "[i]ssues in contract are determined by the law chosen by the parties in accordance with the rule of § 187 and otherwise by the law selected in accordance with the rule of § 188." Id. § 186. Section 187 then states the following:
Under the general choice-of-law approach, incorporation in a jurisdiction is a relevant contact with that jurisdiction, but it is not the only factor to be considered. Courts following this approach will, in some instances, after conducting the requisite balancing of interests, apply the law of the state of incorporation to the controversy. In other instances, however, they may choose to apply a different jurisdiction's rules. Courts following the internal affairs approach, however, will always apply the law of the state of incorporation. In cases where the law of corporate disregard differs substantially among the jurisdictions that have significant contacts with

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or (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.

(3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

ReSTATEMENT (SECOND) section 188 then states the following principles regarding the choice of law in the absence of an effective choice of law by the agreement of the parties:

(1) The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in § 6.

(2) In the absence of an effective choice of law by the parties (see § 187), the contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include: (a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicil, residence, nationality, place of incorporation and place of business of the parties. These contacts are to be evaluated according to their relative importance with respect to the particular issue.

(3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied, except as otherwise provided in §§ 189–199 and 203.

ReSTATEMENT (SECOND) sections 189–199 and 203 then deal with certain specific types of contracts for which special choice of law rules apply, and with certain issues relating to capacity to contract, writing requirements, and usury limitations.

4. See id. §§ 145, 188.

5. See infra Part I.
the transaction at issue or the parties involved, the choice-of-law approach followed may be outcome-determinative.

For example, one important difference among the states in the piercing jurisprudence is whether the issue of whether there are adequate grounds for corporate disregard is regarded as a legal matter for the judge to resolve or instead a factual question to be left to the jury. Courts in different jurisdictions disagree on this issue. Whether a plaintiff has the right to a jury determination on this question can be highly significant and, of course, can also impact the settlement incentives of the parties. This difference between jurisdictions may be limited to piercing controversies, or may in some instances reflect broader jurisdictional differences in the allocation of roles between judges and juries.

Another significant distinction among the states is that the Texas piercing law is an amalgamation of a very pro-piercing court decision and a statute adopted subsequent to, and in response to, “grave concern within the Texas business community” about that decision that imposed significant restrictions on piercing, and which has to some extent legislatively overruled that precedent. The piercing law in all other state jurisdictions, in contrast, has an exclusively common law basis. Texas is also, to my knowledge, the only state that has legislatively imposed the law of the state of incorporation to govern piercing claims against out-of-state corporations. There are a variety of other differences among the states as to their piercing jurisprudence. It may be the case that not all

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7. Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986) (holding that for piercing on the basis of fraud, a showing of constructive fraud is sufficient).
8. ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 283-84 (10th ed. 2007).
9. See TEX. BUS. CORP. ACT ANN. art. 2.21 (Vernon 2003) (imposing stringent limitations on the ability of a plaintiff to argue for veil piercing on the basis of “constructive fraud” or on the basis of the corporation’s failure to follow corporate formalities).
10. See TEX. BUS. CORP. ACT ANN. art. 8.02A (Vernon 2003) (“A foreign corporation . . . shall . . . enjoy the same, but no greater, rights and privileges as a domestic corporation . . . and shall be subject to the same duties, restrictions, penalties, and liabilities now or hereafter imposed upon a domestic corporation of like character . . . .”).
11. For discussion of other significant differences among the states as to their piercing jurisprudence, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 164 (2002) ("Delaware’s veil piercing doctrine is comparatively underdeveloped."); ERIC A. CHIAPPINELLI, CASES AND MATERIALS ON BUSINESS ENTITIES 282-83 (2006) ("Delaware courts are extremely reluctant to pierce . . . . Many
jurisdictions can be easily slotted along a single-dimension continuum with regard to the relative permissiveness of their piercing jurisprudence. Some jurisdictions may be more open to allowing piercing claims on some theories or under some factual circumstances than are some other jurisdictions, yet they also may be relatively more restrictive with regard to other theories or other factual circumstances, making an overall assessment of the relative availability of piercing remedies across jurisdictions more complex.12

12. For example, some jurisdictions may embrace the principle expressed by the California Supreme Court in *Minton v. Cavaney*, 364 P.2d 473, 475 (Cal. 1961), in which it ruled that inadequate capitalization alone may be a basis for allowing a piercing claim, while otherwise embracing a relatively restrictive piercing jurisprudence. On the other hand, some states may instead follow the approach of the
The choice-of-law jurisprudence regarding corporate veil piercing is conflicting and poorly articulated. The majority of courts apply the internal affairs doctrine to impose the law of the state of incorporation upon piercing claims, whether those claims are based on tort judgments or upon contract obligations. However, a number of courts have opted to conduct a more general choice-of-law analysis that focuses instead upon the creditor-corporation relationship and balances the interests of the different jurisdictions that may be involved, which sometimes leads to the courts applying local piercing law—or the law of yet another jurisdiction that is not the state of incorporation—to a piercing controversy involving an out-of-state corporation. The major corporation law casebooks court in Walkovsky v. Carlton, 223 N.E.2d 6, 9 (N.Y. 1966), which is much more restrictive with regard to the significance of undercapitalization, but otherwise embraces a relatively permissive piercing jurisprudence.


and treatises, while unfortunately giving this choice-of-law question only rather cursory treatment, generally recognize this split of authority. I will argue in this Article that determining the body of law to apply to piercing controversies through the application of general choice-of-law principles is a superior approach for accommodating the interests involved, as compared to treating such controversies as internal affairs governed by the law of the state of incorporation. My argument applies both to piercing claims based on tort judgments and to those based upon contractual obligations.

15. See 1 FLETCHER, supra note 13, at § 43.72 ("Veil piercing cases implicate corporate law but involve disputes that reach beyond the confines of the corporation. Thus, some courts have decided that the internal affairs doctrine applies in veil piercing cases and that the law of the state of incorporation should govern, while other courts have disagreed."); see also Bainbridge, supra note 11, at 164–65; HAMILTON & MACEY, supra note 8, at 287–88; SODERQUIST ET AL., supra note 11, at 425; Proceedings, Fourth Annual International Business Law Symposium: Multinational Corporations and Cross Border Conflicts: Nationality, Veil Piercing, and Successor Liability, 10 FLA. J. INT'L L. 221, 270 (1995) (comments of Phillip Blumberg) ("[M]ost courts treat ... piercing the veil as involving the internal affairs of the corporation. ... Many other courts, however, have not looked upon the problem [of piercing] as a corporate problem. ... they treat the choice of law as involving a problem in tort. Where the tort occurred in the forum, these courts often apply the forum's standards on piercing the veil.").

16. I will not address in this Article the question of when federal common law, rather than state law, provides the appropriate legal framework for resolving a piercing controversy. This issue can arise when the underlying claim against a corporation is based upon federal law, such as, for example, the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. §§ 9601–9675 (2000), better known as the "Superfund" law. For a discussion of this question, see Jennifer S. Martin, Consistency in Judicial Interpretation? A Look at CERCLA Parent Company and Shareholder Liability after United States v. Bestfoods, 17 GA. ST. U. L. REV. 409, 427–29, 450–58 (2000); Note, Piercing the Corporate Law Veil: The Alter Ego Doctrine Under Federal Common Law, 95 HARV. L. REV. 853, 859–64 (1982).
Courts that have applied the internal affairs doctrine have badly misjudged the relative merits of these two different choice-of-law approaches. Interestingly, this error has not generally occurred as a result of these courts conducting a full assessment of the matter but for one reason or another according improper weight to the various considerations involved. The error has instead derived primarily from an easily identified source: a widespread and fundamental misunderstanding of the meaning of section 307 of the Restatement (Second) of Conflicts of Laws. This provision, though not embodied in statutory enactments, has nevertheless been very influential and has been misunderstood by many courts to have definitively resolved the choice-of-law question in favor of the internal affairs doctrine. Because these courts have consistently regarded the provision as authoritative, they have further found it unnecessary to conduct an in-depth analysis of the underlying policies and interests implicated by the choice-of-law question, which might reveal this prior error. Other courts have then uncritically relied upon these judicial precedents in which courts have misunderstood section 307.

17. Restatement (Second) section 307 is titled "Shareholders' Liability" and succinctly states the following: "The local law of the state of incorporation will be applied to determine the existence and extent of a shareholder's liability to the corporation for assessments or contribution and to its creditors for corporate debts." Restatement (Second), supra note 3, § 307 (emphasis added).


But some courts do not understand Restatement (Second) section 307 as necessarily calling for application of the law of the state of incorporation. See, e.g., Schwan, 2006 U.S. Dist. LEXIS 28516, at *58–60; Direct Energy Mkts., 2001 U.S. Dist. LEXIS 14356, at *8–10 (applying the law of the jurisdiction of incorporation, but only after conducting a general choice-of-law analysis, and citing section 307 in dicta); Curiale, 1997 U.S. Dist. LEXIS 14563, at *33–37 (citing Int'l Containers in support of applying general choice-of-law principles in piercing controversies involving the rights of parties external to the corporation); Chrysler, 972 F. Supp. at 1102–03 (applying local law); Bankard, 1991 U.S. Dist. LEXIS 17916, at *35–39 (citing section 307 and ultimately applying the law of the state of incorporation to...
In other words, the courts that have followed the internal affairs doctrine have generally not done so as a consequence of considering and rejecting the arguments in favor of the general choice-of-law approach that I will set forth below in Part II of this Article. Rather, they have done so simply because they have either read section 307 literally, and simplistically, as definitively endorsing the internal affairs doctrine approach without considering other relevant provisions of the Restatement (Second) or the underlying objectives sought by its drafters, or because they have uncritically followed earlier precedents so misinterpreting section 307 without giving any real thought to the dubious rationale underlying those precedents.

This judicial error has significant practical consequences for the conduct of piercing litigation. While corporate disregard is a doctrine that is available only to the creditors of closely-held corporations (and not to the creditors of public corporations),20 some corporations are quite large and conduct business in numerous jurisdictions.21 Many piercing claims asserted against the shareholders of the larger closely-held corporations would likely be resolved under the law of a jurisdiction that is not the state of incorporation, were a general choice-of-law analysis conducted by the reviewing court. In addition, in recent years the jurisprudence regarding corporate disregard has diverged more widely among state jurisdic-

20. See HAMILTON & MACEY, supra note 8, at 266 ("Statistically speaking, piercing the corporate veil is entirely a phenomenon of closely held corporations, and predominantly one-person corporations. The corporate form is simply never pierced so as to impose liability against shareholders in a publicly traded corporation."); see also Robert B. Thompson, The Limits of Liability in the New Limited Liability Entities, 32 WAKE FOREST L. REV. 1, 9–10 (1997).
21. Consider, for example, the examples of the Cargill Corporation and the Mars Corporation, both of which are closely-held corporations that are nevertheless quite large and well-known to the public, and which each have very extensive interstate and multi-national operations. See generally Andrew Ross Sorkin & David Barboza, Private Agriculture Giant to Go a Bit Public, N.Y. TIMES, Jan. 27, 2004, at C1 (discussing Cargill); Pamela Sherrid, The Mars Family Faces a Bittersweet Moment, U.S. NEWS & WORLD REP., Aug. 9, 1999, at 42 (discussing Mars).
tions,\textsuperscript{22} therefore making the choice of law applied to resolve a piercing controversy increasingly outcome-determinative.\textsuperscript{23} In particular, the piercing laws of Delaware, New York, and Pennsylvania are regarded by commentators as unusually favorable to the corporate shareholders resisting such a claim.\textsuperscript{24} Consider the situation facing a corporate creditor seeking to have a Delaware- or New York-chartered corporation disregarded to impose liability upon a shareholder in a matter that has some significant contacts with another state that has a more permissive piercing jurisprudence.\textsuperscript{25} That creditor would likely first attempt to persuade the court to apply the more general choice-of-law framework, rather than the internal affairs doctrine approach, so as to give himself a chance to have that more permissive body of law applied. The target shareholder, in contrast, would likely argue for application of the internal affairs doctrine approach so as to avail himself of the more restrictive piercing jurisprudence of the state of incorporation. The piercing jurisprudence of California, in contrast, is re-

\textsuperscript{22} See supra note 11.

\textsuperscript{23} One might argue that, even with the growing divergence among state jurisdictions as to the contours of their piercing jurisprudence, there is inherently enough flexibility in the multi-factor balancing analyses to allow courts to reach whatever results they deem equitable, regardless of the permissive or restrictive language of the applicable precedents in their jurisdiction. In this regard it would be useful to study (1) the extent to which the courts in a given jurisdiction reach consistent results in piercing cases presenting similar fact patterns, and (2) the extent to which courts in different jurisdictions that vary in their piercing jurisprudence reach different results in cases with similar fact patterns. If such a study revealed a pervasive pattern of inconsistency within jurisdictions, or consistency of result across jurisdictions with different formal piercing rules, it would suggest that courts would be less likely to resist my recommendation that they engage in a general choice-of-law analysis to choose the applicable law rather than follow the internal affairs doctrine approach, since the choice-of-law approach followed would not significantly constrain their decisions. If this were, in fact, the case, then I would be forced to concede, and this would also suggest, that the question of the appropriate choice-of-law approach is ultimately of less significance than I claim it to be in this Article.

\textsuperscript{24} See, e.g., Chiappinelli, supra note 11, at 282–84 (discussing Delaware piercing law); Thompson, supra note 11, at 1050, 1052–53; see also Southeast Tex. Inns, Inc. v. Prime Hospitality Corp., 462 F.3d 666, 683 (6th Cir. 2006) (Delaware law requires proof of 'fraud or similar injustice' to pierce a corporate veil . . . . The Tennessee standard appears to be less stringent."

\textsuperscript{25} For current state-by-state summary and comparison of piercing law, see generally the comprehensive treatise by Presser, supra note 11.

\textsuperscript{25} The state of California is one such example. See Soderquist et al., supra note 11, at 425; Thompson, supra note 11, at 1052. For a current state-by-state summary and comparison of piercing law, see generally the comprehensive treatise by Presser, supra note 11.
garded as unusually favorable to piercing attempts, so the contending parties would probably offer the opposite choice-of-law arguments when a piercing claim is being asserted against a California corporation in a matter that has significant contacts with another jurisdiction that has a more restrictive piercing jurisprudence. Finally, Texas law is a complicated mix of statutory and common law elements that is unusually favorable to veil piercing in some regards and unusually unfavorable in other regards, so the decision by the parties whether to advocate for the internal affairs approach or the more general choice-of-law approach (in instances where the choice of law is not statutorily determined) is a more complicated strategic decision.

Sparring over choice-of-law issues before the merits of a piercing claim can be addressed is obviously costly. Moreover, from a broader social perspective, it is undesirable—even apart from its extra costs—since, as I will show, the general choice-of-law approach is superior. Procedural wrangling and its associated costs and delays could be eliminated if the courts came to generally recognize the superiority of the general choice-of-law approach. The application of the internal affairs doctrine to the choice of law applicable to piercing controversies should be discarded forthwith in favor of using more general choice-of-law principles focusing upon the creditor-corporation relationship. The latter approach would better accommodate all of the interests and policies involved, as is discussed in Part II of this Article.

This Article will proceed as follows. In Part I, I will very briefly discuss the general features of the internal affairs doctrine. In Part II, I will explain in some detail why the general choice-of-law approach, rather than the internal affairs doctrine approach, should

26. See Soderquist et al., supra note 11, at 425; Thompson, supra note 11, at 1052; see also Chiappinelli, supra note 11, at 283–84 (discussing a list of nineteen factors considered by California courts in determining whether to pierce). For a current state-by-state summary and comparison of piercing law, see generally the comprehensive treatise by Presser, supra note 11.

27. Under the controlling Castleberry precedent, the question under Texas law of whether the corporate veil should be pierced is regarded as a factual matter for jury determination, see supra note 8, which is not the case in most other jurisdictions. See generally Presser, supra note 11.

28. See Tex. Bus. Corp. Act art. 2.21 (Vernon 2003) (imposing stringent limitations on the ability of a plaintiff to argue for veil piercing on the basis of "constructive fraud" or on the basis of the corporation's failure to follow corporate formalities).

29. See supra note 10 and accompanying text (discussing the statutory limitations imposed by Texas Business Corporations Act article 8.02A).

30. But see supra note 23.
be used to determine the applicable law for resolving piercing controversies whether they are based on tort judgments or instead upon contract obligations. Having made clear the relative advantages of the general choice-of-law approach, in Part III I will discuss the modestly sized—and somewhat disappointing—body of judicial opinions interpreting Restatement (Second) section 307. I will explain how and why section 307 has been misunderstood by some courts as calling for the application of the internal affairs doctrine to piercing controversies, and how those misunderstandings have unfortunately generated a body of precedent with an inertial force of its own. Part IV will present a brief conclusion and my recommendations and will offer some preliminary observations regarding the applicability of my analysis for piercing claims asserted in the context of non-corporate entities such as limited liability companies, limited liability partnerships, and limited liability limited partnerships.

I. THE INTERNAL AFFAIRS DOCTRINE

The internal affairs doctrine is a widely embraced common law rule that provides that disputes regarding the internal affairs of a corporation be resolved in accordance with the law of the state of incorporation.31 This rule applies regardless of any contacts that either the transaction at issue or the parties involved in the dispute may have with other jurisdictions, and regardless of how little contact the transaction or the parties may otherwise have with the state of incorporation, unless the parties have chosen to apply another body of law.32 The doctrine is generally justified as a means of achieving predictability of result and protecting the justified expectations of parties with interests in the corporation, while avoiding subjecting the corporation to inconsistent rules regarding its internal governance procedures.33

For the purposes of this Article, I will assume that the internal affairs doctrine is the correct choice-of-law approach for the courts

31. See Hamilton & Macey, supra note 8, at 197.
33. See id. at 40 (“Unlike more complex conflicts analyses used in other areas of law, the internal affairs doctrine offers a consistent choice of law for firms and their investors, for whom certainty is said to be critical.”); see also Henry Hansmann & Reinier Kraakman, A Procedural Focus on Unlimited Shareholder Liability, 106 Harv. L. Rev. 446, 453 (1992) (quoting First Nat'l City Bank v. Banco Para El Comercio, 462 U.S. 611, 621–22 (1983)); Note, The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for its Continued Primacy, 115 Harv. L. Rev. 1480, 1485–87 (2002).
to use when parties are litigating the contours of an internal corporate relationship, though not all commentators would accept this contention. The greatest uncertainty in the application of the internal affairs doctrine is in determining which contractual or other relationships that persons may have with a corporation constitute such internal relationships and which ones are instead external relationships to which different choice-of-law principles apply, given that all corporate relationships are in a sense external relationships of the corporation with separate juridical persons. Despite the somewhat hazy outer contours of the doctrine, all commentators agree that the relationship between a corporation and its common shareholders is properly regarded as an internal relationship. Similarly, it is undisputed that in the ordinary course of business, the contract creditors and tort judgment creditors of a corporation each have an “external” relationship with the corporation, and the applicable law governing their claims against the corporation should, therefore, be determined by their contractual choice-of-law provisions, if any, or, in the absence of such provisions, by general choice-of-law principles. The relevant question for the purposes of this Article is whether the “external” relationship between a contract creditor or tort judgment creditor and the corporation, or instead the “internal” relationship between the corporation and its common shareholders, should be regarded as the crucial relationship for choice-of-law purposes when a creditor is attempting to have the corporate entity disregarded to hold a particular shareholder personally liable. In the next Part, I will address that question.

34. The internal affairs doctrine, though widely embraced by courts, has come under substantial criticism. One common criticism is that the doctrine lacks a constitutional basis and is supported by, at most, only prudential considerations. See, e.g., Note, supra note 33, at 1482. A recent article by Frederick Tung provides a comprehensive historical account of the development of the internal affairs doctrine in American law. See Tung, supra note 32, at 44-46.

35. Different conflicts principles apply, however, where the rights of third parties external to the corporation are at issue. See Hansmann & Kraakman, supra note 33, at 453; see also Itel Containers Int'l Corp. v. Atlanttrafik Express Serv. Ltd., No. 86 Civ. 1313, 1988 U.S. Dist. LEXIS 7051, at *12-15 (S.D.N.Y. July 13, 1988).

36. See Jed Rubenfeld, State Takeover Legislation and the Commerce Clause: The “Foreign” Corporations Problem, 36 CLEV. ST. L. REV. 355, 376-382 (arguing that the internal affairs doctrine is a vacuous formulation that leaves courts the discretion to classify almost any corporate relationship as either internal or external).

37. See supra note 3 (presenting the RESTATEMENT (SECOND) general framework for determining the choice of law for tort judgment creditor or contract creditor piercing claims).
II.
THE ARGUMENT AGAINST APPLYING THE INTERNAL AFFAIRS DOCTRINE TO CHOOSE THE APPLICABLE LAW FOR PIERCING CONTROVERSIES

Corporate creditors with contract claims differ significantly from tort judgment creditors in that they have had the opportunity to contractually specify what body of law will govern any later disputes, including any later piercing controversies. This difference is significant for choice-of-law purposes. I will therefore analyze the choice-of-law question for piercing controversies based upon underlying tort judgments separately from those based upon corporate contractual obligations.

A. Tort Judgment-Based Piercing Claims

At first consideration, it would appear that simple fairness concerns would mandate that a tort judgment-based piercing claim should be decided under the body of law that is applicable for determining the rights of the external tort creditor against the corporation, rather than under the law of the state of incorporation that would be imposed under the internal affairs doctrine. Otherwise, the controlling shareholders of a corporation that are potentially subject to liability from successful piercing claims would have the incentive to incorporate in a jurisdiction with a relatively restrictive piercing jurisprudence. Further, once incorporated in such a jurisdiction, they could lend their support to efforts to have their jurisdiction impose—legislatively and/or judicially—an even more restrictive piercing law so as to more fully externalize the impacts of any inequitable corporate conduct, conduct for which they might be held liable under more permissive piercing rules. Legislators or judges who sought to make the jurisdiction more attractive for incorporation or reincorporation would, therefore, be inclined to support those efforts, since the jurisdiction would receive all of the benefits of any increased incorporation activity while much of the costs imposed on corporate tort creditors would affect citizens of other jurisdictions.

This is particularly the case in a jurisdiction such as Delaware, which has chartered many corporations that conduct virtually all of their business outside of the state.

38. This is true in theory, although as a practical matter transaction costs may prevent the parties from negotiating a comprehensive choice-of-law provision that would specifically address piercing claims.

39. Although not all of those costs would be externalized, since some of the tort judgment creditors disadvantaged by a restrictive piercing jurisprudence would be citizens of the corporation's state of incorporation.
The academic commentators who have considered the matter have generally concluded that these fairness arguments outweigh any concerns posed by the potential loss of predictability and uniformity if the applicable law must be determined in each instance by a more general choice-of-law balancing analysis. However, assessment of the relative merits of the different choice-of-law approaches for tort-based piercing claims is somewhat more complicated than it may first appear.

First, from an economic efficiency point of view, the relevant question is which of the two possible choice-of-law approaches will be more likely to lead to the application of the most efficient piercing jurisprudence. In other words, the question is which body of jurisprudence gives corporate shareholders the appropriate ex ante incentives to take all cost-effective measures to avoid inequitable corporate conduct with regard to corporate tort creditors, but not sufficient incentive to take further prophylactic measures to limit the possibility of the corporation's engaging in such inequitable

40. The eminent corporate law scholars Henry Hansmann and Reinier Kraakman, for example, have clearly and succinctly rejected the internal affairs doctrine choice-of-law approach for tort judgment-based piercing claims as inviting "gross opportunism" on the part of shareholders to externalize costs:

[A]llowing a state like Delaware to determine the scope of tort liability for companies incorporated under its law invites gross opportunism on the part of both the state and the shareholders who invest in its corporations. If, for example, Delaware amended its corporation law to limit corporate liability for tort judgments to the par value of the shareholder's stock (which most corporations set at zero), we assume that nobody would seriously argue that the internal affairs doctrine requires that the new rule be respected. And if Delaware adopted a restrictive veil-piercing rule that (together with the state's liberal policy toward the creation of subsidiary corporations) effectively permitted the same result, it is not obvious that, under a reasonable conflict of laws doctrine, such a rule deserves anymore respect than would the par value rule.

. . . . "To give conclusive effect to the law of the chartering state in determining whether the separate juridical status of its instrumentality should be respected would permit the state to violate with impunity the rights of third parties . . . ."

Hansmann & Kraakman, supra note 33, at 451, 453 (quoting First Nat'l City Bank v. Banco Para El Comercio, 462 U.S. 611, 621–22 (1983)). Another noted scholar, Franklin Gevurtz, has also concluded that the internal affairs doctrine should not apply to tort judgment-based veil piercing claims, since tort creditors have no way to avoid these inequitable consequences. Gevurtz, supra note 6, at 904 ("Contract creditors might adjust . . . to compensate for risks of dealing with corporations from different states with varying willingness to pierce. . . . [T]ort victims cannot make such adjustments. This strongly suggests that the internal affairs rule is inappropriate for piercing.

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conduct when those measures are not cost-effective in terms of the magnitude of the harms prevented.\textsuperscript{41} A piercing jurisprudence that is too permissive would encourage shareholders to take excessively expensive precautionary measures to ensure that their corporations do not act in such a way as to expose them to personal liability for unsatisfied corporation tort judgments, or else to bear the costs of reincorporating elsewhere if that were a more effective means of avoiding the consequences of that overly permissive piercing jurisprudence. Similarly, an overly restrictive piercing jurisprudence would undercut the incentives of the shareholders of local corporations to take cost-justified prophylactic measures and would encourage out-of-state corporations to reincorporate in the jurisdiction to lessen shareholder exposure to such piercing claims.

Whether the use of the internal affairs doctrine approach is inefficient in this regard is a complicated and difficult question. Use of this approach to select the applicable body of law does give corporate shareholders the unseemly incentive to incorporate (or reincorporate) in jurisdictions with a relatively restrictive piercing jurisprudence.\textsuperscript{42} But it may be the case, under some circumstances, that those jurisdictions' more restrictive piercing jurisprudence will actually provide more efficient incentives for shareholders than would the overly permissive piercing jurisprudence imposed under the more general choice-of-law approach. The existence of incentives for corporations and their shareholders to behave opportunistically does not necessarily mean that the resulting changes in their behavior would lead away from, rather than toward, efficiency. A more complex analysis that compares the piercing law of each jurisdiction to a hypothetical standard of efficient piercing rules\textsuperscript{43} would be necessary to determine whether the opportunistic incentives provided by the internal affairs doctrine choice-of-law approach are efficient or inefficient.

Another complicating factor that must be considered when assessing the relative efficiency of the two different choice-of-law approaches is that differences among jurisdictions as to their piercing

\textsuperscript{41} The determination of the efficient piercing rules, to which the piercing jurisprudences of the different jurisdictions should be compared to gauge their relative efficiency, would depend upon an assessment of the social costs and benefits of allowing various kinds of piercing claims to succeed. For a discussion of the efficiency of the principle of limited liability and various departures from this principle allowing piercing claims to succeed, see generally David Millon, \textit{Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability}, 56 EMORY L.J. 1305 (2007).

\textsuperscript{42} See Hansmann & Kraakman, \textit{supra} note 33, at 451.

\textsuperscript{43} See id.
jurisprudence is only one of many factors influencing incorporation or reincorporation decisions. Moreover, it is a factor that one would suspect would play only a relatively minor role in the locus of incorporation decision, as compared to more significant considerations, such as administrative cost and convenience, general governance rules, or state taxes or franchise fees. In some instances, differences among jurisdictions as to the relative permissiveness of their piercing jurisprudence may be substantial enough to influence incorporation or reincorporation decisions, if the internal affairs doctrine approach is followed. But in most cases one would expect those jurisprudential differences to not be significant enough or predictable enough to influence these particular decisions. They might well affect, at most, only the extensiveness of measures taken to avoid shareholder-piercing liability. The extent to which adjustments in corporate behavior would result for a particular corporation from judicial application of the internal affairs doctrine approach rather than a general choice-of-law approach would appear to depend upon which specific jurisdictions are being compared and the many other circumstances facing that particular corporation. The empirical research relating to the importance of the differences in the piercing jurisprudence across jurisdictions relative to other factors is quite sparse, and more research along these lines would be helpful in establishing the relative sensitivity of incorporation or reincorporation decisions to these various factors.

It would be impossible at this point to offer any sweeping generalizations as to the relative economic efficiency of the two possible choice-of-law approaches for resolving tort judgment-based piercing controversies. To do so, it would be necessary to first conduct a fact-specific study to determine to what extent incorporation or reincorporation decisions would be altered by a change in the

44. There is, however, one recent and interesting study that attempts to isolate and quantify the various factors that influence incorporation decisions for privately held corporations, and which includes variations in piercing jurisprudence as one of the explanatory factors in the regression model there utilized. See Jens Dammann & Martha Schündeln, The Incorporation Choices of Privately Held Corporations (The Univ. of Tex. Sch. of Law, Law & Econ. Research Paper No. 119, 2007), available at http://ssrn.com/abstract=1049581. That study, while noting that the vague standards of piercing law make it difficult to evaluate differences in piercing risk, did conclude that there was statistically significant support for the conclusion that "the higher the percentage of cases in which the veil was pierced, the lower the likelihood that a corporation from that state incorporates locally." Id. at 15, 23. Further, the study concluded that the statistical support for this conclusion was strongest for firms in the range of 100-5000 employees, but weaker for firms of sizes outside this range, and that these results were robust with regard to different regional and industry aggregations. Id. at 23, 27.
choice-of-law approach applied in tort judgment-based piercing controversies, and what changes, if any, those corporations would make in their internal control procedures to lessen shareholder piercing exposure.

For those corporations whose incorporation or reincorporation decisions would be influenced by a change in the choice-of-law approach, it would then be necessary to determine when such a change in approach would result in a change in the body of law applicable to those corporations' particular tort claim-based piercing controversies. Under some (and perhaps most) circumstances, a move to a general choice-of-law balancing analysis would still result in the application of the law of the state of incorporation.\textsuperscript{45} For those instances in which the different choice-of-law approaches would, in fact, lead to the application of a different body of law, it would be necessary to compare the piercing law of the two relevant jurisdictions to determine what effects, if any, this change of law would have for the resolution of those controversies.\textsuperscript{46} Whether or not a change in the choice-of-law approach would result in a change in where a particular corporation incorporates, it would still be necessary to see whether the change in approach would result in a different level of corporate effort to preclude tort judgment-based piercing claims from succeeding or even arising, and then determine whether that changed conduct were a move toward or away from efficient levels of precaution. To answer all of these questions, a comprehensive and complex study of the comparative efficiency effects of these different choice-of-law approaches would have to be undertaken. Such a study, to my knowledge, has not yet been attempted.

Yet another necessary dimension of a comparative efficiency assessment would be a comparison of the extent to which either of the two different choice-of-law approaches provides greater social benefits due to greater predictability and/or uniformity as to the applicable law, since, other things being equal, greater predictability and uniformity of law both facilitate planning, and thus contribute to efficient resource use. The application of the internal affairs doctrine would make the determination of the applicable body of

\textsuperscript{45} This would likely often be the case, since piercing is a doctrine that is applicable only to closely held corporations, and many (though not all) closely-held corporations are small corporations that engage in only local activities; so a general choice-of-law balancing analysis done in connection with a tort judgment-based piercing claim would often also lead to the choice of the law of the state of incorporation.

\textsuperscript{46} See supra note 11 and accompanying text; see also supra note 45.
law more predictable and uniform, as it would eliminate the need for undertaking an unpredictable balancing analysis. However, scholars regard these benefits of greater predictability and uniformity provided by the internal affairs approach in the piercing context to be quite small.47

One reason for this is that many (though not all)48 states have roughly similar piercing jurisprudence. Another reason is that often the more general choice-of-law approach will also lead to application of the law of the state of incorporation, therefore maintaining uniformity.49 A third reason is that the use of a more general choice-of-law approach is unlikely to create a problem of subjecting a corporation to inconsistent internal governance demands, as opposed to merely establishing the most permissive jurisdiction's jurisprudence as the minimum threshold that corporate and/or shareholder conduct must meet to avoid potential shareholder liability for unsatisfied corporation tort judgments in all jurisdictions.50

47. See Thompson, supra note 11, at 1054 (“[Departure from the internal affairs doctrine approach to choice of law in veil piercing controversies] can create uncertainty if multiple states seek to apply differing rules of limited liability to the same corporation. However, given the small number of piercing cases decided in many jurisdictions and the similar results in many states, this degree of uncertainty does not seem large.”). One might question whether this 1991 observation by Thompson has since been undercut somewhat by the growing divergence among jurisdictions in their piercing jurisprudence. See supra note 11 and accompanying text.

48. See supra note 11 and accompanying text.

49. This approach, however, would necessarily be somewhat less predictable as to when courts would reach this choice-of-law result than would be the internal affairs doctrine approach.

50. See Gevirtz, supra note 6, at 904 (“What about concerns over imposing inconsistent state rules for corporate governance? Here, one must look at the specific grounds for piercing. . . . A more persuasive case for a single standard exists for piercing based upon . . . inadequate capitalization. . . . Even here, however, we will not be dealing with a situation (which might exists for some issues in corporate governance) in which one state could command actions that another prohibits.”). But see Janet Cooper Alexander, Unlimited Shareholder Liability Through a Procedural Lens, 106 HArv. L. Rev. 387, 410–15 (1992) (advocating on uniformity-of-law grounds for the use of the internal affairs doctrine to impose the law of the state of incorporation for tort judgment-based piercing claims). Alexander states:

“The internal affairs doctrine responds to the need for a uniform law governing the structural relationships of corporations that act in numerous states. To permit each state to impose unlimited shareholder liability through its tort law would make uniformity impossible, and would thus defeat an important principle of the substantive law of corporations.”

Id. at 413. Of course, no state's piercing law comes anywhere close to imposing such “unlimited shareholder liability” for all unsatisfied tort judgments against a
Given all these uncertainties as to the relative efficiency of the two different choice-of-law approaches, it does not appear possible to choose between them on that basis. As to the relative equitable consequences of the two different approaches, the scholarly consensus is that the application of general choice-of-law principles would be much fairer than the application of the internal affairs doctrine approach for corporate tort claimants who have no control over incorporation decisions or over out-of-state lawmakers. These scholars have concluded that equity requires that the legal rules governing piercing should generally be designed to make it more difficult for corporations and their shareholders to externalize the costs of their conduct. The application of the internal affairs doctrine to choose the law of the state of incorporation as the applicable law for tort judgment-based piercing controversies would appear to facilitate, rather than retard, such inequitable externalization.

Since there is no clear evidence available at this time regarding the relative efficiency properties of the two different approaches, I favor the tentative adoption of what I agree with other commentators is the fairer approach of applying general choice-of-law principles to determine the applicable body of law for tort judgment-based piercing controversies. This approach would allow courts the latitude to consider the interests of a jurisdiction in protecting the legitimate rights and interests of its tort victim citizens against the inequitable actions of out-of-state corporations and, where appropriate, to apply their own (or yet another) jurisdiction's piercing jurisprudence. It is therefore preferable to having the courts apply the law of the state of incorporation in all instances.

But what if the piercing claim is based upon a corporate contract obligation? The comparative analysis of the merits of the two

corporation, and therefore Alexander's expressed concerns about the lack of uniformity consequences of a move to a more general choice-of-law approach for piercing controversies seem somewhat exaggerated.

51. See supra note 41 and accompanying text.
52. See supra note 41 and accompanying text
53. See supra note 41 and accompanying text
54. See, e.g., Gevirtz, supra note 6, at 904; Hansmann & Kraakman, supra note 33, at 450–53.
55. See supra note 3 (presenting the RESTATEMENT (SECOND) general choice-of-law framework for tort judgment-based piercing claims pressed by external parties).
56. Should it be determined at some future time, however, that the internal affairs doctrine approach has some significant offsetting economic efficiency advantages over the more general choice-of-law approach, I would then favor reconsideration of this question in light of that new evidence.
different choice-of-law approaches in this context is similar to, but in some regards more complicated than, the comparable analysis for tort judgment-based piercing controversies. I will present this analysis below.

**B. Contract-Based Piercing Claims**

A corporate contract creditor, at least in theory, has had the opportunity to negotiate not only a contractual choice-of-law term governing any disputes with the corporation under the contract, but also an agreement with the corporation and its shareholders as to which jurisdiction's law would apply to piercing claims. Courts should honor such a comprehensive choice-of-law agreement in a contract, absent any showing that the body of law chosen is somehow inappropriate (as under other circumstances). Therefore, the choice-of-law approach that should be followed to govern contract obligation-based piercing claims should be a default rule that would apply only when the parties have failed to fully specify their agreement. However, it is exceedingly rare for the parties and the corporation shareholders to also agree as to which body of law will govern any piercing attempts that may arise from those contractual obligations.\(^5\) The default rule utilized will, therefore, be applied to choose the governing body of law in almost all contract obligation-based piercing controversies.

What choice-of-law approach should the courts follow to fill such a gap in the agreement? The conventional default rule approach for filling contractual gaps is for courts to attempt to determine the appropriate implied-in-fact term—to replicate the hypothetical bargain that the parties would have reached had they been able to negotiate costlessly the relevant terms.\(^5\)\(^8\) Obviously, each party to a contract would prefer that the applicable governing law were the law of the jurisdiction most favorable to that party, all

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\(^{5}\) This is in contrast to the common situation in which parties to a corporate contract include a choice-of-law provision that specifies which body of law will govern any contractual disputes. I am not personally aware of any situations in which the parties to a corporate contract have gone beyond including in their agreement a choice-of-law provision governing contractual disputes to also negotiate choice-of-law agreements with the corporation and its shareholders that would govern piercing claims. Parties may sometimes also negotiate shareholder guarantees of corporate obligations in connection with such contracts, and those guarantees may include their own choice-of-law provisions, but those provisions generally address only disputes that may arise under the guarantee contracts and not possible piercing controversies relating to the underlying corporate obligation.

things considered, with the piercing jurisprudence of each jurisdiction being only one aspect of that determination. What choice-of-law provisions governing piercing attempts would likely be reached in such hypothetical agreements? What factors should the courts consider in determining what the parties to a particular piercing controversy would have agreed to as to the applicable body of law?

This is another question difficult to answer in general terms. First of all, it is clear that one should not assume that the fact that the creditor and the corporation have agreed to have the law of the state of incorporation govern any disputes arising under the contract indicates that the parties would necessarily also want that jurisdiction's piercing law to apply when the corporate creditor seeks to hold a corporate shareholder personally liable. The question of the rights of a corporate creditor against a corporate shareholder who was not a party to the creditor's contract with the corporation is distinct from—and collateral to—the rights of the contracting parties inter se. The parties involved may wish to have a different

59. A party could, of course, attempt to negotiate a more complex choice-of-law provision with the laws of different jurisdictions applying to different issues that may arise under the contract, in an attempt to obtain application of the most favorable existing body of law for each possible issue. However, in practice one does not see such detailed negotiations over choice-of-law issues, probably because the transaction costs involved in reaching such a detailed agreement would be prohibitive relative to the magnitude of expected benefits. I will therefore make the simplifying assumption for this Article that each party to a corporate contract would seek to have the law of a single jurisdiction applied to all disputes that may arise either under that contract or with regard to possible piercing controversies.

60. See Dassault Falcon Jet Corp. v. Oberflex, Inc., 909 F. Supp. 345, 348 (M.D.N.C. 1995) ("Defendant SIO requests the court to apply North Carolina law on the grounds that the purchase order contained a choice of law provision electing North Carolina law. However, a choice of law provision in a contract is not binding on what law to apply for piercing the corporate veil. The reason for this is that the issue of piercing the corporate veil is collateral to and not part of the parties' negotiations or expectations with respect to the contract. It involves imposing liability on third-party shareholders as opposed to governing the parties' obligations under the contract."); see also impulse Mktg. Group, Inc. v. Nat'l Small Bus. Alliance, No. 05-CV-7776, 2007 U.S. Dist. LEXIS 42725, at *24 (S.D.N.Y. June 12, 2007); Rondout Valley Cent. Sch. Dist. v. Coneco Corp., 339 F. Supp. 2d 425, 440 (N.D.N.Y. 2004); United Trade Assocs. Ltd. v. Dickens & Matson (USA) Ltd., Inc., 848 F. Supp. 751, 759 (E.D. Mich. 1994) ("Although the choice of law clause directs this Court to interpret the contractual dispute under English law, the issue of piercing the corporate veil is collateral to the contract and thus this Court is not bound by the choice of law provision.").

body of law apply to such piercing controversies than to disputes arising under the contract that do not involve potential shareholder liability. The choice by the parties of the law of a jurisdiction to govern contractual disputes does not necessarily indicate that they would want the choice-of-law rules of that jurisdiction to also be used to determine the applicable law for a piercing claim.\textsuperscript{62}

One can certainly envision that corporations and their shareholders would commonly favor application of the law of the state of incorporation to any piercing controversies, particularly if the corporation is incorporated in a jurisdiction, such as Delaware or New York, that has a relatively restrictive piercing jurisprudence.\textsuperscript{63} But it seems unlikely that the corporation's contract creditors would be willing to agree to this choice of law without demanding some offsetting concessions that the corporation and/or its shareholders might be unwilling to grant, particularly if the creditor and/or the contract has significant contacts with a jurisdiction with a more permissive piercing jurisprudence, which might lead to that jurisdiction's law being applied under a general choice-of-law analysis. Therefore, determining what the parties to a particular corporate contract and the corporation's shareholders would have collectively agreed to as to the choice of law to govern piercing controversies, had they been able to negotiate this matter, requires a difficult and very fact-specific inquiry. No general inferences can be drawn simply from the parties' use of a contractual choice-of-law provision. And, of course, if the parties have not even included a choice-of-law provision to govern contractual disputes, there is even less of a basis for inferring what body of law the parties and the corporation's shareholders would have wanted to apply to possible later piercing controversies.

It thus appears that where the parties to a corporate contract and the corporation's shareholders have not agreed among themselves as to the body of law to govern a piercing controversy relating to that contract, the reviewing court will be faced with a choice among several alternative courses of action. One possibility would be for the court to do the focused, fact-specific inquiry necessary to determine what these particular parties would have likely agreed to as between the two choice-of-law approaches here considered, had

\textsuperscript{62} See, e.g., Dassault Falcon, 909 F. Supp at 348 ("[A] choice of law provision in a contract is not binding on what law to apply for piercing the corporate veil.").

\textsuperscript{63} See supra notes 24–30 and accompanying text.
they addressed the matter, and follow that approach. A second possibility would be to simply arbitrarily embrace one or the other of the two choice-of-law approaches as a default rule without conducting such an inquiry, hoping to motivate prospective contracting parties to engage in bargaining from that default rule position to expressly choose their preferred governing body of law. A third tack would be to first handle the question in the same manner as one would approach tort judgment-based piercing controversies (where there was, of course, no prior choice-of-law agreement reached among the parties) and balance efficiency and equity considerations in a general way to determine the socially optimal choice-of-law approach, and impose that approach as a basis for subsequent bargaining by prospective parties.

The last of these approaches would appear to be the most feasible and sensible option, given the significant burdens involved in conducting a fact-specific inquiry as to the parties' likely actions had they addressed the matter, and given the possibility that any default rule arbitrarily imposed may prove difficult for some parties who would ideally favor application of another rule to contract around. However, as discussed above, there is not sufficient information available to determine the comparative efficiency properties of the two different choice-of-law approaches in the tort judgment-based piercing claim context, and the situation appears to be for similar reasons the same with regard to contract obligation-based piercing claims. The selection of a choice-of-law approach therefore should again be made on equitable grounds. For the reasons discussed above with regard to tort judgment-based piercing claims, I also conclude that the use of general choice-of-law principles to determine the applicable law to govern these contract obligation-based piercing controversies would provide the superior framework for allowing courts the latitude to consider the interests of each jurisdiction involved in protecting the legitimate rights and interests of its citizens, and where appropriate to apply their own (or yet another) jurisdiction's piercing jurisprudence, while still allowing parties to contract for the applicability of another body of law to piercing controversies.

My overall conclusion is, therefore, that the courts should apply general choice-of-law principles to choose the governing body of law in piercing controversies, whether those claims are based upon underlying tort judgments or instead upon contract obligations, except for the rare instance of contract obligation-based

64. See supra notes 41–56 and accompanying text.
piercing claims where the parties involved have specifically agreed as to the body of law to govern such claims. They should not apply the law of the state of incorporation to resolve those claims unless that choice of law is indicated as appropriate by general choice-of-law principles. The analysis that leads to this conclusion is, as shown above, rather straightforward. So why have the majority of courts that have addressed the matter failed to reach this seemingly obvious result?

The answer here, in my opinion, has to do primarily with some courts’ misunderstanding of the meaning of *Restatement (Second)* section 307 and the subsequent precedential force of those erroneous rulings. Section 307 is a terse provision that is misleading if read in isolation. A comprehensive textual analysis of the entire *Restatement (Second)* and its predecessor, *Restatement of Conflicts of Laws*, should lead one to conclude that section 307 does not mandate application of the law of the state of incorporation to piercing controversies. However, a more superficial consideration of section 307, apart from its comments and its broader *Restatement (Second)* and *Restatement of Conflicts of Laws* context, can easily lead a court astray. I will discuss the interpretation of section 307 and the court rulings applying this provision to piercing controversies in the next Part of this Article.

III.

INTERPRETATION OF SECTION 307 OF THE *RESTATEMENT (SECOND) OF CONFLICTS OF LAWS*

A. A Textual Interpretation of Section 307

*Restatement (Second)* section 307 is very succinct and is set forth below in its entirety:

§ 307. Shareholders’ Liability

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65. Some commentators have argued that there also exist broader economic and political factors that may influence courts to sometimes apply the law of a foreign jurisdiction to disputes that, as is sometimes the case for piercing controversies, would be more appropriately resolved under local law. Robert Flannigan, for example, has argued that in recent years there has been an expansion of the limitations on liability granted to business entities, both through the adoption of local statutory limitations and through greater deference shown to the liability limitations contained in the law of the state of chartering of a foreign business entity. Flannigan argues that this expansion of limitations on liability is due to the fear of local governments that they would otherwise lose economic activity to other jurisdictions. *See*, e.g., Robert Flannigan, *The Political Path to Limited Liability in Business Trusts*, 31 *Advocates’ Q.* 257, 265–73 (2006).
The local law of the state of incorporation will be applied to determine the existence and extent of a shareholder's liability to the corporation for assessments or contributions and to its creditors for corporate debts.\textsuperscript{66}

\textsuperscript{66} Restatement (Second), \textit{supra} note 3, § 307. Because of the significance of this provision, the full text of the comment and of the reporter's note to section 307 is set forth below:

\textbf{Comment: a. Rationale.} Under the local law of most states, a shareholder is liable for any balance that remains unpaid upon a subscription made by him to the shares of a corporation. Shareholders of certain corporations, such as banks and mutual insurance companies, are also made liable in some states for a further amount, which is generally limited either to the par value of their shares or to their pro rata portion of the corporation's debts. Sometimes liability is imposed upon the shareholders for such debts as the corporation incurs while engaging in business before its capital stock (or a portion of its capital stock) has been paid in.

The local law of the state of incorporation will be applied to determine the liability to which a person subjects himself by purchasing, or subscribing to, shares of a corporation. This law will likewise be applied to determine whether the shareholder's liability runs to the corporation, or to its creditors, or to both the corporation and its creditors. The local law of the state of incorporation will be applied to determine such issues because (1) this is the law which the shareholders, to the extent that they thought about the question, would usually expect to have applied to determine their liability, (2) exclusive application of this law will assure uniform treatment of shareholders or of classes of shareholders and (3) this state will usually have the dominant interest in the determination of this issue.

The local law of the state of incorporation may impose liability on the shareholders for any debt of the corporation, whether liquidated or unliquidated and irrespective of the state where it is payable or where it was incurred. Such liability may be imposed upon all shareholders. On the other hand, the local law of the state of incorporation may classify the shareholders and, if the classification is reasonable, it may impose liability for debts of the corporation upon some classes and not upon others. Thus, only shareholders who have not fully paid for their shares or who have paid otherwise than in cash may be made liable to creditors of the corporation for its debts.

\textit{b.} As to the law which will be applied to determine who are shareholders of a corporation, see § 303.

\textit{c.} The method of enforcing a shareholder's liability by proceedings outside the state of incorporation is considered in § 308.

\textit{d.} Reference is to "local law" of state of incorporation. The reference is to the "local law" of the state of incorporation and not to that state's "law," which means the totality of its law including its choice-of-law rules.

\textit{e.} A court will refuse to entertain a cause of action that is penal or that is contrary to a strong local public policy (see §§ 89–90).

REPORTER'S NOTE [citations omitted]. \textit{Liabilities imposed upon shareholders of foreign corporation.} A state may impose liability upon a shareholder of a foreign corporation for an act done by the corporation in the state, if the state's relationship to the shareholder is sufficient to make reasonable the imposition of such liability upon him. [citations omitted].
Since, as will be discussed below, courts have taken the sparse language of section 307 very seriously and literally, a textual analysis of that section, such as one would normally apply to a statute rather than to a Restatement provision, is in order. Section 307, on its face, appears to support the internal affairs doctrine choice-of-law approach to piercing controversies, since both the contract obligations of and the tort judgments against a corporation are "corporate debts," and a successful piercing claim makes the target shareholder liable to the corporate creditor to whom that debt was owed. However, if one carries out a more comprehensive textual analysis that considers also the comment and reporter's note to section 307, as well as the related Restatement (Second) introduction and sections 297, 302, and 306 and their comments, it becomes relatively clear that it was not the intent of the drafters of section 307 to mandate the application of the law of the state of incorporation to all piercing claims. In addition, if one also reads the provisions of the earlier Restatement of Conflicts of Laws from which the relevant Restatement (Second) provisions were derived, it becomes even clearer that section 307 was not intended to accomplish this end.

Let me first discuss how Restatement (Second) sections 297, 302, and 306, the comments to sections 297, 302, and 307, and the reporter's note to section 307, together make clear the intent of the drafters that section 307 not be given a literal, simplistic reading that would necessarily impose the law of the state of incorporation for all piercing controversies. I will then discuss how this conclusion is given further support by the text of the predecessor Restatement of Conflicts of Laws and by the introduction to the Restatement (Second), which explains what the drafters of that document were trying to accomplish with their comprehensive revisions to the original Restatement of Conflicts of Laws.

Restatement (Second) section 302 addresses certain choice-of-law issues that may arise with respect to the rights and duties of a corporation, and it states in qualified fashion that the law of the state of incorporation will generally be applied to resolve such issues "except in the unusual case where . . . 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."67 Section 302 thus creates merely a rebuttable presumption in favor of applica-

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67. Restatement (Second), supra note 3, § 302. Section 302 is titled "Other Issues with Respect to Powers and Liabilities of a Corporation," and states in its entirety:

(1) Issues involving the rights and liabilities of a corporation, other than those dealt with in § 301, are determined by the local law of the state which, with
tion of the law of the state of incorporation to issues relating to corporate rights or duties, one that can be overcome by a showing of a more significant relationship of another jurisdiction under general choice-of-law principles.68 This intent is made even clearer by comment e to that section, which states that while internal corporate governance matters must for practical reasons be consistently governed by the law of the state of incorporation,69 this is not true for "the making of contracts, the commission of torts and the transfer of property. There is no reason why corporate acts of the latter sort should not be governed by the local law of different states."70

Section 302 thus was not intended to mandate the application of the law of the state of incorporation for issues relating to corporate contract or tort obligations, let alone for issues relating to the collateral matter of shareholder personal liability running directly to creditors for those obligations. Comment e draws a distinction between those internal governance issues—in which uniform treatment is paramount—and those contractual or tort liability issues—in which the application of local law may well be more appropriate.71 While section 302 and its comments do not specifically address personal shareholder liability through piercing claims, such piercing claims are grounded upon corporation contract or tort obligations to external creditors, areas in which, unlike in internal governance matters, uniformity is not a critical consideration. Accordingly, comment e's statement that there is no reason local law

68. See supra note 3 and accompanying text.
69. RESTATEMENT (SECOND), supra note 3, § 302, cmt. e ("[M]any matters involving a corporation cannot practicably be determined differently in different states. Examples . . . include steps taken in the course of the original incorporation, the election or appointment of directors and officers, the adoption of by-laws, the issuance of corporate shares . . . the holding of directors' and shareholders' meetings, methods of voting including any requirement for cumulative voting, the declaration and payment of dividends and other distributions, charter amendments, mergers, consolidations, and reorganizations, the reclassification of shares and the purchase and redemption by the corporation of outstanding shares of its own stock.").
70. Id.
71. See id.
should not be applied to contract or tort issues would appear germane to providing guidance in the piercing context as well.\textsuperscript{72}

\textit{Restatement (Second)} section 306 addresses the choice of law for disputes regarding the obligations owed by the majority shareholders of a corporation to the minority shareholders.\textsuperscript{73} It notes that the relationship between a majority shareholder and the minority shareholders is an internal affair that should generally be governed by the law of the state of incorporation, but in circumstances in which another state has a more significant relationship to the parties involved, that other state’s law should govern.\textsuperscript{74} This provision’s recognition of the primacy of the “most significant relationship” principle over the internal affairs doctrine presumption for even a quintessential internal affair such as intra-shareholder relationships strongly suggests that the \textit{Restatement (Second)} drafters would want this general choice-of-law approach to also be given primacy for piercing claims raised by external corporate creditors.

\textit{Restatement (Second)} section 297 succinctly states that “Incorporation by one state will be recognized by other states.”\textsuperscript{75} Comment \textit{c} to that section elaborates more fully on what the drafters intended by that provision with regard to shareholder liabilities:

\begin{quote}
\textit{c. Limitation of shareholders’ liability. Insofar as this protection is accorded them in the state of incorporation, a state will \textit{usually} recognize the immunity of the shareholders of a foreign corpo-
\end{quote}

\textsuperscript{72} Hansmann and Kraakman also argue that section 302 and comment \textit{e} to that section undercut the argument for a literal, simplistic reading of section 307. Hansmann & Kraakman, \textit{supra} note 33, at 450–51. Their conclusion, however, is that while section 302 and its comment together suggest that section 307 should not be read as mandating the application of the law of the state of incorporation to tort judgment-based piercing claims—a position that I agree with—section 307 should be so understood with regard to contract obligation piercing claims—a position that I reject in this Article. \textit{Id.} at 451.

\textsuperscript{73} \textit{Restatement (Second), supra} note 3, \S\ 306 (“Liability of Majority Shareholder. The obligations owed by a majority shareholder to the corporation and to the minority shareholders will be determined by the local law of the state of incorporation, except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in \S\ 6 to the parties and the corporation, in which event the local law of the other state will be applied.”); \textit{see also} Curiale v. Tiber Holding Corp., No. CIV.A.95-5284, 1997 U.S. Dist. LEXIS 14563, at *36 (E.D. Pa. Sept. 18, 1997) (“Section 307 cannot be read in a vacuum; rather, Section 307 must be read in conjunction with Section 306 . . . and, ‘contrasting Section 307 with Section 306 . . . shows that the Restatement did not mean for section 307 to be applied in cases such as that present here.’”) (citation omitted).

\textsuperscript{74} \textit{Restatement (Second), supra} note 3, \S\ 306.

\textsuperscript{75} \textit{Id.} \S\ 297.
ration from being sued as individuals on matters arising out of the acts or omissions of the corporation . . . . 76

Section 297 was thus again intended only to create a rebuttable presumption that the law of the state of incorporation be applied to govern piercing controversies, one that could be rebutted under the unusual circumstances of the parties' and/or the controversy's having more significant contacts with another jurisdiction.

Turning to Restatement (Second) section 307 itself, we can see that its comments give no examples that definitively clarify whether the section's "corporate debts" phrase is intended to apply only in those instances in which a shareholder has not fully satisfied his assessment responsibilities or contribution to corporate capital obligations, or instead is intended to apply more broadly to all corporation contract and/or tort obligations as well. 77 Comment a begins by justifying the general application of the law of the state of incorporation to shareholder liability questions on shareholder expectations and uniformity of treatment grounds, 78 and further states that the "state [of incorporation] will usually have the dominant interest in the determination of this issue." 79 It then notes that the local law of the state of incorporation may impose liability for corporate obligations on some or all of the corporation's shareholders. 80 However, comment a then concludes with a much more restrictive summary declaration: "Thus, only shareholders who have not fully paid for their shares or who have paid otherwise than in cash may be liable to creditors of the corporation for its debts." 81

This conclusion as to the very limited scope of section 307 shareholder liability, along with the comment's failure to provide other examples of shareholder liability that section 307 would impose, suggests, as do sections 302 and 306, that section 307 is intended to address only the question of shareholder liability for corporate debts under circumstances in which shareholders have not met their initial assessment or capital contribution obligations to the corporation. It suggests that it was not intended to apply more generally to impose the law of the state of incorporation upon

76. Id. § 297 cmt. c (emphasis added).
77. Hansmann & Kraakman, supra note 33, at 451; see also Itel Containers Int'l Corp. v. Atlanttrafik Express Serv. Ltd., No. 86 Civ. 1313, 1988 U.S. Dist. LEXIS 7051, at *12-15 (S.D.N.Y. July 13, 1988) (arguing that section 307 has no application to piercing controversies and addresses only the situation in which shareholder liability would be based solely upon the ownership of shares without more).
78. RESTATEMENT (SECOND), supra note 3, § 307 cmt. a.
79. Id.
80. Id.
81. Id.
piercing claims that do not involve such contribution deficiencies, although, in my opinion, this comment alone is not clear enough to necessarily compel such a conclusion.\textsuperscript{82} This narrower interpretation of the intended scope of section 307 is, however, given even further support by the brief reporter's note to that section, which directly contradicts any interpretation of section 307 that would mandate application of the law of the state of incorporation to all piercing controversies, stating that this law should be imposed only when "reasonable," presumably with regard to the application of general choice-of-law principles. The full text of that reporter's note is given below:

\emph{Liabilities imposed upon shareholders of foreign corporation}. A state may impose liability upon a shareholder of a foreign corporation for an act done by the corporation in the state, if the state's relationship to the shareholder is sufficient to make reasonable the imposition of such liability upon him.\textsuperscript{83}

Consideration of these other portions of the \textit{Restatement (Second)} thus indicates that a literal, simplistic reading of the facially broad "shareholder's liability . . . for corporate debts"\textsuperscript{84} phrase of section 307 would be inappropriate and that section 307 is better read as establishing only, at most, a rebuttable presumption that the law of the state of incorporation should be applied to piercing controversies and that a general choice-of-law analysis should be conducted before this determination is made.

Consideration of the relevant provisions of the predecessor \textit{Restatement of Conflict of Laws} and of the Introduction to the \textit{Restatement (Second)} also provides further support for this interpretation of

\textsuperscript{82} Another commentator, Mark Patterson, does take the position that comment \textit{a} to section 307 makes it quite clear that section 307 was intended by its drafters to apply only to shareholder liability for deficient initial contributions and not to questions of shareholder liability to a corporation creditor. See Mark R. Patterson, \textit{Is Unlimited Liability Really Unattainable? Of Long Arms and Short Sales}, 56 \textit{Ohio St. L.J.} 815, 863 (1995) ("Although this section [307] appears at first glance to be helpful, and is treated as dispositive [in favor of imposing the law of the state of incorporation to piercing controversies] by Professor Alexander, the comments to section 307 make clear that it applies only to the situation in which 'liability is imposed upon the shareholders for such debts as the corporation incurs while engaging in business before its capital stock (or a portion of its capital stock) has been paid in.' Neither section [301 or 307], then, decides which law should govern the liability to a third party of a shareholder of a corporation following the corporation's initial capitalization.") (referring to Alexander, \textit{supra} note 50, at 410–15).

\textsuperscript{83} \textit{Restatement (Second), supra} note 3, § 307 reporter's note.

\textsuperscript{84} \textit{Id.} § 307.
section 307. The most relevant provision of the *Restatement of Conflicts of Laws* is section 185, which provides:

*Shareholders' Liability to Assessments or Contribution.* The existence and extent of the liability of a shareholder for assessments or contribution to the corporation for the payment of debts of the corporation is determined by the law of the state of incorporation.  

The close parallels between the text of section 185 and that of *Restatement (Second)* section 307 show that section 185 was the main predecessor to section 307. It differs from the later provision in wording only, in subtle yet significant ways. First, the title of section 185 is much more closely focused on assessment and capital contribution issues than is the broader "Shareholder's Liability" title of *Restatement (Second)* section 307. Second, the language of section 185 speaks only to shareholder liability to the corporation for assessments or contributions and not to liability running directly to corporate creditors for corporation obligations. Comment a to section 185 makes clear the intended narrow scope of section 185, stating: "The rule stated in this Section is applicable to the creation of liabilities of a shareholder for assessment by or contributions to the corporation itself. Direct liability of shareholders to the creditors of the corporation may be imposed by states other than that of incorporation (see Section 191)."  

Section 191, in turn, implicitly endorses a general choice-of-law analysis by calling for the application of local law to these issues where the target shareholder has the requisite contacts with that jurisdiction.  

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86. Id. cmt. a.
87. See id. § 191.
88. Id. § 185.
89. Id. § 191.
There is no precise analog to section 191 of the original Restatement of Conflicts of Laws included in the Restatement (Second). It thus appears that Restatement (Second) section 307 was intended by its drafters to consolidate sections 185 and 191 of the Restatement of Conflict of Laws into a single, more succinct provision. However, the drafters of the Restatement (Second) appear to have inadvertently overlooked the point that these two Restatement of Conflict of Laws provisions impose different choice-of-law rules for the two different forms of shareholder liability, one running to the corporation in instances of assessment or contribution deficiencies and the other running directly to corporation creditors. While Restatement (Second) section 307 is based primarily on the wording of Restatement of Conflicts of Laws section 185, there is nothing in the comments to section 307 evidencing an intent to impose the section 185 law of the state of incorporation mandate to also govern shareholder obligations formerly addressed with a different choice-of-law approach under Restatement of Conflicts of Laws section 191. As discussed above, what germane comments and reporter's notes do exist in the Restatement (Second) in fact suggest the contrary. The choice-of-law approach that the drafters of the Restatement (Second) wanted to be applied to determine the body of law governing shareholder obligations to corporate creditors in piercing controversies remains the Restatement of Conflicts of Laws section 191 general choice-of-law principles approach.

In addition, the introduction to the Restatement (Second) makes clear that the essential thrust of the entire extensive drafting effort was to replace the rigid rules of the Restatement of Conflict of Laws with standards of greater flexibility.\textsuperscript{90} An interpretation of section 307 that would force different shareholder liability situations that are addressed by different choice-of-law rules under sections 185 and 191 of the Restatement of Conflicts of Laws to be addressed in a uniform fashion that ignores relevant distinctions would seem to directly counter the purpose of the revisions embodied by the Restatement (Second).

\textsuperscript{90} Restatement (Second), supra note 3, at vii ("[There has been an] enormous change in dominant judicial thought respecting conflicts problems that has taken place in relatively recent years. The essence of that change has been the jettisoning of a multiplicity of rigid rules in favor of standards of greater flexibility, according sensitivity in judgment to important values that were formerly ignored. . . . [B]lack-letter formulations often must consist of open-ended standards . . . . That technique is not unique to Conflicts but the situation here has called for its employment quite pervasively throughout these volumes. The result presents a striking contrast to the first Restatement in which dogma was so thoroughly enshrined.").
In summary, it is evident that, read in isolation, the literal text of section 307 can be read to suggest that the law of the state of incorporation should be applied to all piercing controversies. However, a more comprehensive analysis of the Restatement (Second) clearly indicates that the appropriate interpretation of that section is to create, at most, a rebuttable presumption that the law of the state of incorporation be applied, and that, moreover, the courts should first conduct a general choice-of-law analysis giving proper weight to the interests of each of the jurisdictions that have significant contacts with the parties or with the transaction at issue before choosing the governing law. So how have the courts handled this question? Let me now turn to the relevant cases.

B. Judicial Interpretation of Section 307

The Restatement (Second) was officially promulgated in 1969 after going through a process of numerous preliminary drafts for almost two decades. Since that date, there have been only a modest number of cases invoking section 307 in the piercing context. As I will discuss below on a case-by-case basis, the courts that have applied this provision have been drastically split over whether the provision calls for the application of the law of the state of incorporation to all piercing controversies or merely creates, at most, a rebuttable presumption in favor of applying that state's law.

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As noted above, the casebooks and academic commentators have recognized this split of authority. Moreover, none of the cases that have interpreted section 307 as calling for the sweeping application of the law of the state of incorporation have gone beyond a superficial textualist justification and offered any plausible policy justifications for taking that tack.

For the first two-plus decades after the promulgation of the Restatement (Second), there was relatively little judicial attention paid to section 307. Only a handful of cases through 1991 cited the provision. The earliest judicial reference to section 307 of which I am aware was in 1980 in Realco Services, Inc. v. Holt, a case involving an attempt by New York corporation creditors to pierce the corporate veil of a New Jersey corporation in a Pennsylvania federal court. In Realco, the court noted in a footnote, without elaboration, that "New Jersey law controls the question of formal corporate existence," citing Restatement (Second) sections 298 and 307 in support of that position. That opinion suggests, but does not clearly embrace, the position that section 307 calls broadly for the application of the law of the state of incorporation to all piercing controversies. It certainly does not engage in any sustained analysis as to whether the application of the law of the state of incorporation to all piercing controversies is a good idea that would merit deference to the persuasive authority of section 307, even assuming that provision is interpreted in that manner.

The next case citing section 307 was decided in 1983. In Klika v. Aerolite SPE Corp., an Ohio federal court held, without extensive discussion, in a contract obligation-based piercing controversy, that section 307 "requires that the law of the state of incorporation ap-

93. See supra notes 13–14 and accompanying text.
94. See supra note 15 and accompanying text.
96. Id. at 439.
97. Id. at 442 n.8.
98. To further support this somewhat ambiguous proposition, Realco also cites Restatement (Second) section 298, which calls for courts to treat corporations that have met their state of incorporation's formal requirements as corporations of the states in which those courts sit with regard to the applicable formalities. Id. at n.8; Restatement (Second), supra note 3, § 298. Section 298 does not specifically address veil-piercing choice-of-law issues. Restatement (Second), supra note 3, § 298. The Realco decision should therefore perhaps be read more narrowly as addressing choice-of-law questions only with regard to determining whether a corporation has met the necessary formalities imposed by state law to qualify for corporate status, and not as addressing veil-piercing attempts.
plies in an action to pierce the corporate veil."^{100} The ruling also appeared to be based simply on a literal reading of the text of section 307, without further analysis.

The next judicial reference to section 307 did not come until 1988. In *Kempe v. Ocean Drilling & Exploration Co.*,^{101} a federal district court sitting as a Louisiana state court for a piercing controversy concluded that there was "little doubt" that a Louisiana court would apply the law of the jurisdiction of incorporation (Bermuda), citing in support of this position both section 307 and the general embrace of the underlying *Restatement (Second)* premises by Louisiana courts.^{102} However, that court also noted that the *Restatement (Second)* provisions "contemplate the application of interest analysis to piercing the corporate veil claims."^{103} The court ultimately chose to apply the law of the jurisdiction of incorporation because that jurisdiction had greater interests in the matter than did the jurisdiction of Louisiana,^{104} thus reducing its invocation of section 307 as providing support for the application of the law of the jurisdiction of incorporation to dicta.

A second 1988 case, *Itel Containers Int'l Corp. v. Atlantictrafik Express Service Ltd.*,^{105} also cited section 307, but it interpreted it narrowly as applying only to questions of shareholder liability for corporate obligations that may arise solely on account of the shareholder's owning shares without more; it further held that this provision had no relevance to piercing controversies where it was alleged that the target shareholder had engaged in inequitable conduct.^{106}

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100. *Id.* at *8 n.5.
102. *Id.* at 1072.
103. *Id.*
104. *Id.* at 1072-73.
106. *Id.* at *12-15* ("The fact of incorporation in a foreign state is but one contact, and it falls far short of being the most relevant one. . . . Section 307 refers to the liability to which a person subjects himself merely by holding shares in a corporation, and has no bearing on the extraordinary situation in which the privilege of incorporation has been abused to the detriment of a third party. Nor is the rationale of the Section pertinent here, inasmuch as it fails to take account of the interests of third parties. . . . The Reporter's Note to Section 307, indeed, recognizes that '[a] state may impose liability upon a shareholder of a foreign corporation for an act done by the corporation in the state, if the state's relationship to the shareholders is sufficient to make reasonable the imposition of such liability upon him.' . . . The better reasoned view weighs in the balance the contacts of the third party with the state of incorporation. . . . Where those contacts are nil, fairness to the third party does not permit the introduction of foreign law upon nothing more substantial than the circumstance of incorporation in a foreign state." (internal citations omitted)).
That court refused to apply the law of the state of incorporation to the piercing controversy since the defendant corporation had conducted no business in its state of incorporation.\textsuperscript{107}

\textit{In re Blanton}\textsuperscript{108} was a 1989 case in which a Texas federal court cited section 307 for the proposition that the law of the state of incorporation should be applied to all piercing controversies.\textsuperscript{109} That statement, however, was only dictum because the parties in that case did not dispute the applicable law.\textsuperscript{110} In 1990, the Tenth Circuit Court of Appeals, in \textit{Cascade Energy \& Metals Corp. v. Banks},\textsuperscript{111} cited section 307 as providing support for application of the law of the state of incorporation\textsuperscript{112} in discussing (again in dicta) the issues presented by the choice-of-law question, but the court did not attempt to definitively resolve this question.\textsuperscript{113}

The next case citing section 307 was a 1991 opinion, \textit{Foster v. Berwind Corp.}\textsuperscript{114} In that case, the plaintiff, the Pennsylvania Insurance Commissioner, sought to pierce a subsidiary corporation chartered in Bermuda, but which did no business there, to hold its Pennsylvania-chartered corporate parent liable for certain contractual debts of the subsidiary.\textsuperscript{115} The Pennsylvania federal court hearing the case cited section 307 for the proposition that the law of the state of incorporation should be applied to piercing controversies, but it held that section 307 was inapplicable to the particular situation before it; instead, the court stated that section 306 governed the case before it and that section 306 specifically called for a more general choice-of-law analysis rather than application of the law of incorporation.\textsuperscript{116} The court then applied local Pennsylvania law to the dispute on the basis of its analysis.\textsuperscript{117}

The \textit{Foster} court's invocation of section 306 to govern the dispute is facially inappropriate, given that section 306 by its explicit terms applies only to intra-shareholder disputes and not to piercing controversies.\textsuperscript{118} The court apparently understood section 307 as calling for the application of the law of the jurisdiction of incorpo-
ration; in the situation before the court, in which the subject corporation had no meaningful contact with the jurisdiction of incorporation except for the act of incorporation, the court did not like that result and found another way to justify to its satisfaction conducting a more general choice-of-law analysis that led to the application of another jurisdiction's laws.

These seven early judicial opinions citing section 307 during the first two-plus decades after its promulgation thus provide, at most, very ambivalent and qualified support for interpretation of that provision as calling for the application of the law of the state of incorporation to all piercing controversies. Klika flatly held that section 307 "requires" that the law of the state of incorporation be applied to all piercing controversies.119 The Realco Services, Blanton, and Foster opinions each seem to implicitly accept the interpretation that section 307 at least recommends that result,120 though none of these opinions includes any supporting analysis that would justify this interpretation. The Kempe opinion, in contrast, quotes section 307 without comment as to its scope of application, but then, in effect, subordinates that provision to the Restatement (Second)'s overall policy of favoring a more general choice-of-law analysis.121 And at the other extreme, the Itel Containers court, in the only one of these early section 307 opinions that analyzes the question in any depth, flatly rejects any interpretation of section 307 that would call for application of the law of the state of incorporation to all piercing controversies.122 That court instead regards section 307 as addressing the choice of law only in those cases in which shareholder liability might be imposed solely on the basis of a person's owning shares without more and takes the view that it is inapplicable altogether to piercing controversies in which inequitable shareholder conduct is alleged, where instead general choice-of-law principles should be applied.123

Despite this rather sparse and conflicting body of early precedents, a number of opinions issued in the mid-1990s assumed, as if

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119. Klika v. Aerolite SPE Corp., No. C82-522, 1983 U.S. Dist. LEXIS 11023, at *8 n.5 (N.D. Ohio Dec. 8, 1983, amended Jan. 7, 1984). The RESTATEMENT (SECOND) provides, of course, only persuasive and not mandatory authority, so the Klika court is obviously incorrect in stating that section 307 "requires" the application of the law of the state of incorporation. However, the opinion is clear that the court interprets section 307 as recommending this position.

120. See supra notes 95–98, 108–10, and 114–18 and accompanying text.

121. See notes 101–04 and accompanying text.

122. See notes 105–07 and accompanying text.

it were a matter of settled law not requiring further justification, that section 307 called for application of the law of the state of incorporation to all piercing controversies.\textsuperscript{124} Some other courts during that period (or earlier) also reached the same conclusion as to the application of the law of the state of incorporation to all piercing controversies without invoking section 307.\textsuperscript{125} There have been additional rulings since the mid-1990s that take this same position regarding section 307.\textsuperscript{126} On the other hand, several later courts have followed the rationale of \textit{Itel Containers} and rejected an interpretation of section 307 that requires application of the law of the state of incorporation to all piercing controversies, and they have instead applied general choice-of-law principles to choose the governing body of law.\textsuperscript{127}

\textsuperscript{124} See, e.g., Kalb, Voorhis & Co. v. Am. Fin. Corp., 8 F.3d 130, 132–33 (2d Cir. 1993) ("Texas substantive law applies to this alter ego claim because Texas is the place of... incorporation.") (citing without discussion \textit{Restatement (Second) of Conflicts of Laws}; Maltz v. Union Carbide Chem. & Plastics Co., 992 F. Supp. 286, 300 n.12 (S.D.N.Y. 1997) (applying the law of the state of incorporation to a piercing controversy and citing \textit{Restatement (Second) of Conflicts of Laws} section 307 in support of this result); Amoco Chem. Co. v. Tex. Tin Corp., 925 F. Supp. 1192, 1201 (S.D. Tex. 1996); Resolution Trust Corp. v. Latham & Watkins, 909 F. Supp. 923, 935 (S.D.N.Y. 1995) ("[Section 307 and prior Florida cases suggest] that Delaware law [the law of the state of incorporation]... would apply in a suit to pierce the corporate veil... "); Realmark Inv. Co. v. Am. Fin. Corp., 171 B.R. 692, 694 (N.D. Ga. 1994) ("[I]t appears to the Court that the Georgia Supreme Court would follow the Restatement [(Second) of Conflicts of Laws], and the Court holds that the state of incorporation's law applies to issues of piercing the corporate veil.") (citing without discussion \textit{Restatement (Second) of Conflicts of Laws}; \textit{In re R.C.S. Engineered Prods. Co. v. Himmelspach}, 168 B.R. 598, 602 (Bankr. E.D. Mich. 1994).


\textsuperscript{127} See, e.g., Schwan v. CNH Am. LLC, No. 4:04-CV-3384, 2006 U.S. Dist. LEXIS 28516, at *58 (D. Neb. May 4, 2006) (applying the local Nebraska law rather
In summary, the section 307 case law consists of, first, a modest number of judicial opinions that apply a literal and simplistic textual analysis and call for applying the law of the state of incorporation to all piercing controversies and, second, a smaller number of opinions that consider also the underlying policy of the Restatement (Second) to encourage a broader choice-of-law analysis that takes into account the interests of all affected jurisdictions. These latter cases then—not surprisingly—conclude that section 307 was not intended to impose the law of the state of incorporation to piercing controversies except when a more general choice-of-law analysis suggested that this is the appropriate body of law.

The latter group of courts has it right as to the interpretation of section 307. A broader textual analysis and reflection upon the underlying policy considerations justify their conclusions. As I have noted above, one could perhaps argue that the courts that have misinterpreted section 307 have, in at least some instances, been covertly attempting to make their jurisdictions more attractive as a locus of business operations to those foreign corporations chartered in states with a relatively more restrictive piercing jurisprudence. However, I think that these errors of interpretation can be adequately explained by the simple fact that section 307 is easy to misunderstand if it is read in isolation, rather than along with its comments and reporter's note and in its broader Restatement (Second) context, and the facially absolute language of that provision has unfortunately encouraged courts to avoid conducting this more extensive and time-consuming interpretive effort. Further-


128. See Flannigan, supra note 65, at 263-73.
more, such misunderstandings have now created a body of precedential authority, which has made it even easier for later courts, which may wish to avoid making the considerable efforts required to revisit first principles of choice of law whenever settled law makes it unnecessary to do so, to unwittingly to fall prey to the same pitfalls.

IV. CONCLUSION AND RECOMMENDATIONS

A. Choice of Law in Corporate Veil-Piercing Litigation

Given the divergence among jurisdictions as to their piercing law, the choice-of-law approach followed can have outcome-determinative consequences. The choice-of-law issue thus gives rise to preliminary procedural struggles, which make it more difficult and expensive to reach the merits of piercing controversies. It would be more efficient if the choice-of-law question were definitively resolved in favor of the better approach.

The general choice-of-law approach that considers and balances the interests of all jurisdictions that are involved is, in my opinion, the better approach for determining the applicable law for both tort judgment-based and contract obligation-based piercing claims than is summary application of the law of the state of incorporation under the internal affairs doctrine. Unfortunately, it is not possible at this time to offer a definitive assessment as to which choice-of-law approach would better promote overall economic efficiency, although it does appear that the significance of the predictability and uniformity advantages often claimed for the internal affairs doctrine approach is overstated in the piercing context. However, the general choice-of-law approach is clearly more equitable to both corporate tort judgment and contract creditors. In particular, this approach removes the ability of corporations and their shareholders to limit the shareholders' exposure to piercing claims merely by selectively incorporating or reincorporating in jurisdictions such as Delaware or New York that have a relatively restrictive piercing jurisprudence, and thereby externalizing the consequences of their inequitable conduct, while still allowing the parties the freedom to expressly contract for whatever body of law that they wish to have govern piercing controversies.

The majority of courts that have considered the issue have unfortunately followed the internal affairs doctrine approach. However, those courts have not done so because they have considered and rejected the policy arguments that I have offered in this Article
in favor of the general choice-of-law approach, but instead because they have relied upon a literal and simplistic reading of section 307 of the Restatement (Second) that they have construed in isolation without also considering the other relevant sections, comments, and reporter's notes and the underlying purposes of the Restatement (Second). Other courts, however, have considered section 307 in this broader context and have understood it to, at most, create a rebuttable presumption that the law of the state of incorporation be applied—a presumption that should then be evaluated and in some instances overcome through a more general choice-of-law assessment.

These latter courts have it right, in my opinion, and I recommend that all courts henceforth utilize general choice-of-law principles to select the applicable body of law to apply to piercing controversies raised in the corporate context, whether those controversies are based upon underlying tort judgments or instead upon contract obligations. The only exception to this principle that I would allow are those exceedingly rare instances of contract obligation-based piercing claims in which the corporate creditor, the corporation, and the target shareholder(s) have all specifically agreed not only as to which body of law shall govern any disputes arising under the contract, but also as to which jurisdiction's laws shall govern any piercing claims that may later arise.

B. Choice of Law in Piercing Litigation Involving Non-Corporate Entities

Choice-of-law issues similar to those discussed above can also arise when a tort or contract creditor of a non-corporate limited liability entity, such as a limited liability partnership or limited liability limited partnership (hereinafter "LLP" or "LLLPP"), or a limited liability company (hereinafter "LLC"), seeks to have an LLP or LLLP general partner or an LLC member held personally liable for the entity's obligation. The choice-of-law questions presented in these non-corporate contexts are in some instances broader in scope than those that I have here discussed and, consequently, may be outcome-determinative under a broader range of circumstances. This is so because there may not only be differences in the relevant piercing jurisprudence across jurisdictions for a particular entity form, but also differences in the extent of limited liability protec-

129. But see id. (suggesting that there may be a covert and more political rationale underlying these decisions).
tion provided under the relevant chartering statutes and differences as to whether a particular entity form is permitted at all to conduct certain types of business as a limited liability vehicle in that jurisdiction. Under those latter circumstances, the choice of law may be outcome-determinative even if the piercing jurisprudence is identical across the relevant jurisdictions.

My analysis of choice-of-law issues in the corporate veil-piercing context leads to a similar conclusion for the LLP, LLLP, and LLC contexts. The applicable body of law for resolving a controversy in which an entity creditor seeks to have an LLP or LLLP general partner or LLC member held personally liable for an entity obligation, whether under a veil-piercing theory or under the theory that the applicable law does not provide protections against personal liability for entity obligations even absent a justification for piercing, should be determined through application of general choice-of-law principles. The law of the state of organization of the entity should not be imposed by analogy to the corporate internal affairs doctrine. The rationale for this conclusion is exactly the same as discussed above in the corporate veil-piercing context. Such controversies are better regarded as external matters based upon the creditor's claim against the entity than as internal affairs relating to the LLP or LLLP partner's or LLC member's relationship to the entity, and therefore the choice of law should be guided by general choice-of-law principles that better address and balance the interests and equities involved than does the internal affairs rule.

Some commentators have, however, argued that application of the law of the state of organization of the entity is appropriate in

130. For example, for the LLP form, some jurisdictions provide only "partial shield" (sometimes called "narrow shield") protection for the general partners against tort claims against the LLP for torts with which those partners were not involved and had no knowledge of, but do not provide any protection against being held personally liable for the contract obligations of the LLP. Other states, in contrast, provide "full shield" (sometimes called "broad shield") protection that not only provides the general partners with similar protection against personal liability for tort claims, but also shields them from personal liability for the contractual obligations of the LLP. See Hamilton & Macey, supra note 8, at 50-52.

131. See Thomas E. Rutledge, To Boldly Go Where You Have Not Been Told You May Go: LLCs, LLPs, and LLLPs in Interstate Transactions, 58 Baylor L. Rev. 205, 226-27 (2006) ("[A] crucial qualifier to ... the respect for the limited liability afforded to a foreign entity by the jurisdiction of organization is the limitation of the foreign structure to activities that could be carried on by the equivalent domestic structure. ... [which is not always permitted by] the various LLC ... acts.") (citing the Uniform Limited Liability Company Act and the Kentucky and Texas statutes).
such controversies, at least for LLCs, and perhaps for LLP’s and LLLP’s as well. As support for this position, however, those commentators generally do not offer a convincing principled justification for departing from general choice-of-law principles in adjudicating the rights of entity creditors, which as discussed above would be difficult if not impossible to do. They essentially assert, without supporting discussion, that *Restatement (Second)* section 307 mandates the application of the law of the state of incorporation to corporate veil-piercing controversies and that the decision by the drafters of the *Restatement (Second)* to take this position, presumably so as to promote predictability and uniformity across jurisdictions, is consistent with court rulings and should be regarded as broadly authoritative and be extended to apply to similar controversies involving non-corporate limited liability entities.

However, the better reading of *Restatement (Second)* section 307 is that it calls for application of the law of the state of incorporation to piercing controversies in the corporate context only when this result is justified by general choice-of-law principles. This conclusion also equally undercuts the use of section 307 as persuasive authority for applying the law of the state of organization to resolve claims by LLP, LLLP, and LLC creditors that seek to hold certain partners or members of those entities personally liable for those claims. The law governing claims of these sorts should also be determined through the use of general choice-of-law principles, and not in accordance with the internal affairs rule.

132. See, e.g., id. at 238 ("LLC members in a foreign jurisdiction, even a non-LLC jurisdiction, should enjoy the limited liability afforded by the jurisdiction of incorporation.").
133. See id. at 238-42.
134. See id. at 230-31.
135. Id. at 216 ("[C]ourts apply [the internal affairs rule] to . . . whether a foreign jurisdiction should pierce the corporate veil, and questions of shareholder limited liability. While this application appears contrary to the label 'internal affairs,' it is actually appropriate as it addresses when the owners (shareholders) should be held liable for a corporate debt that cannot be satisfied out of available corporate assets.").
136. See id. at 238-42.