# WHITHER INTERNAL AFFAIRS

## State Regulation of the Internal Affairs of Foreign Not-for-Profit Corporations:

## An Exploratory Discussion*

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**October 2005**

There is currently a spate of proposed, and in the case of California, actually passed, state legislation which would attempt to regulate the behavior of not-for-profit corporations. These legislative initiatives come in the wake of for-profit corporate scandals – Enron, Tyco, WorldCom – and the passage of the Sarbanes-Oxley Act. Most attempt, in one way or another, to regulate corporate conduct in the areas of conflicts-of-interest and governance structures (such as by requiring audit committees) and other matters related to internal governance. There is also the possibility of federal legislation which may attempt to regulate the internal governance of not-for-profit corporations.

Given these developments, there does not seem to be much discussion of whether a not-for-profit corporation, operating in one or more states other than its state of incorporation, must comply with any of the new laws in states other than its state of incorporation which may conflict both with each other and with those of the entity's state of incorporation.

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* This paper could not have come into being without the expert assistance of my colleagues Jean Tom and Emily Ritter, to whom I am extremely grateful.

This paper will provide a brief overview of the so-called “Internal Affairs Doctrine,” which provides that the law of the state of an entity’s incorporation will be looked to for general governance matters, and its constitutional base and then will examine it briefly in the light of the proposed and actual legislation of New York, Massachusetts and California.

## 1. The Issue

Under the judicially-developed Internal Affairs Doctrine, the internal corporate affairs[1] of a business or nonprofit corporation have traditionally been governed by the laws of its state of incorporation, even when the corporation’s business and assets are primarily located in another state. Thus, for example, questions concerning the rights and duties of the directors of a Delaware corporation would be governed by Delaware law, even if the organization had all its employees and its office in New York State. This doctrine is enshrined in the Model Business Corporation Act §15.05 (Official Comment), the Restatement (Second) of Conflict of Laws § 302, the U.C.C. § 8-106 (1977), and in numerous state and federal cases,[2] and is considered a foundational aspect of corporate law.

Recently, several states have passed statutes or have legislation pending which attempt to regulate the internal affairs of foreign not-for-profit corporations (i.e., corporations incorporated in other states) doing business within their borders. For instance, California’s recently enacted Nonprofit Integrity Act of 2004, which amends the California Uniform Supervision of Trustees for Charitable Purposes Act (USTCPA), imposes new audit requirements (e.g., a requirement for certain organizations (those with over $2 million in annual gross revenues) to have an audit committee of the board and dictates the composition of the audit committee (no more than 50 percent of the audit committee members may sit on the finance committee), as well as forbidding compensation of audit committee members), compensation procedures, and fundraising regulations for applicable organizations.[3] It purports to include within its reach foreign organizations of a certain size which are conducting activities or holding

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[1] Typically, “internal affairs” are thought to be matters peculiar to the relationships among or between a corporation and its officers, directors and shareholders / members, e.g., the fiduciary duties of directors and officers, the election and qualification of directors, the holding of director and member meetings, committee structures, voting rights, director and officer liability, the adoption of bylaws, bylaw and charter amendments, mergers and dissolution.

[2] *See, e.g., First National City Bank v. Banco Para el Comercio*, 462 U.S. 611 (1983).

[3] Uniform Supervision of Trustees for Charitable Purposes Act, section 12586(e)(1), (2), (f), (g).

property in California. Moreover, while it is not clear from the face of the statute, the California Attorney General is currently taking the position that the USTCPA (as amended by the Nonprofit Integrity Act) applies to foreign organizations doing business within the state, and doing business includes charitable solicitation:

> "The Act applies to all foreign charitable corporations (corporations formed under the laws of other states) doing business or holding property in California for other purposes. Doing business in California includes soliciting donations in California by mail, by advertisement in publications or by any other means from outside of California….[4]"

New York State's Not-for-Profit Corporation Law ("N-PCL") currently contains provisions which explicitly govern the liability of directors of foreign corporations for certain actions and the recourse that can be taken against them for misconduct (Sections 719, 720 and 1318), as well as other internal governance matters of foreign corporations such as member derivative actions (Sections 623 and 1320) and the indemnification of directors and officers (Sections 721 and 1320). What is interesting is that when you wade through the convoluted sections of the N-PCL regarding the application of its provisions to foreign corporations, certain sections are limited to requests made by New York State resident members (section 1316, requirement to produce membership records; section 1319 requirement to disclose certain financial information under Article 5), and a Type B foreign corporation (i.e., a charitable entity) is exempt from certain provisions if (i) its principal activities are conducted outside New York, (ii) the greater part of its property is located outside New York, and (iii) less than 10 percent of its annual revenue is derived from the solicitation of funds within New York.[5] So at least in

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[4] The California Attorney General's website has a section answering frequently asked questions regarding the Nonprofit Integrity Act of 2004. See http://www.ag.ca.gov/charities/faq.htm#nol.

[5] N-PCL Section 1321. This scheme is similar to that found in California's Nonprofit Corporation Law (NCL) (California's equivalent of the N-PCL) which requires foreign corporations to comply with Chapter 21 of California's General Corporation Law, applicable to for-profit and not-for-profit foreign corporations (NCL Section 6910), and deals primarily with the service of process, annual registration and the like, and not issues involving internal affairs. Moreover, the factors which determine whether a foreign corporation is subject to California's corporate laws, GCL 2115, and which uses a mathematical equation of property, payroll and sales ratio, is specifically not applicable to not-for-profit corporations. NCL Section 6910. GCL Section 2116, however, makes directors of a foreign corporation liable for unauthorized dividends, purchase of shares or distribution of assets, or false certificates, reports or public notices or other violations of official duty *according to the applicable laws of the state of incorporation* (emphasis added).

some instances the New York State legislature has tipped its hat to the concept of having certain required contacts with New York in order to come within its regulatory authority.

In early 2005, the New York Attorney General, Eliot Spitzer, introduced legislation aimed at reforming the charitable sector.[6] Certain provisions would apply to foreign corporations and would, in some cases, affect foreign corporations' internal affairs.

The proposed legislation would amend N-PCL Section 520, currently applicable to foreign corporations, to (a) clarify that annual reports filed by not-for-profit corporations shall be complete and accurate; (b) provide that the persistent failure to file complete and accurate reports shall be a breach of the directors' and officers' duty to the corporation; and (c) provide that such persistent failure shall subject the directors and officers to an action for removal.[7] Currently, the only remedy for a foreign corporation's failure to file reports is that the New York Attorney General may enjoin the corporation's activities in New York State.

While not explicitly applicable to foreign corporations, the proposed legislation would amend N-PCL Section 712 to require an executive committee (if the board has more than twenty-five members) and an audit committee (if the corporation's financial statements are audited by a public accountant or it accrues in any fiscal year gross revenues and support of at least two million dollars) and states the duties of the audit committees and the limitations on compensation to be paid to audit committee members, presumably to ensure their independence.[8]

The proposed legislation would also amend N-PCL Sections 723 and 724, currently applicable to foreign corporations with certain minimum contacts with New York (discussed above). The proposed legislation would amend the requirement that certain directors or officers named in a lawsuit post a bond and would also add a provision requiring notice to the

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[6] AG 63-05 (S. 4111, A. 7580), AG 64-05 (S. 5238, A. 7822), AG 65-05 (S. 5237, A. 7824), AG 67-05 (A. 7579), AG 68-05 (S. 5235, A. 7825).

[7] Attorney General's Legislative Program Bill #68-05, Section 1.

[8] Attorney General's Legislative Program Bill #68-05, Section 3. The executive and audit committee provisions do not apply to any corporation whose certificate of incorporation or bylaws prohibit either type of committee, but in such a case the duties specified for the audit committee must be performed by the entire board of directors.

New York Attorney General of any application to a court for indemnification of a director or officer.[9]

Finally, the proposed legislation would enact a new Section 727, applicable to foreign corporations authorized to do business in New York, as well as New York corporations. Section 727 would require corporations to maintain internal financial controls designed to reasonably ensure that material financial information relating to the corporation be made known to the corporation's board of directors by others within the corporation. The provision would require officers to report to the corporation's auditors and its board of directors (or audit committee) any significant deficiencies and material weaknesses in the design or operation of any such internal financial controls; any fraud, whether or not material, involving management or other employees having a significant role in the corporation's internal financial controls; and any material information indicating that the financial information included in any report of the corporation required pursuant to Section 520 does not fairly present in all material respects the financial condition and results of the operations of the corporation.[10]

In addition to the N-PCL, New York also currently regulates charities under Executive Law 7A (requiring charities that solicit contributions to register and report) and the Estates, Powers and Trusts Law ("EPTL") section 8-1.4 (requiring charities that have property or conduct activities in New York to register and report). Like the California Attorney General, the New York State Attorney General has taken the position that under the EPTL, he has the authority to oversee and regulate any charitable "trust" that has assets in New York State, the word "trust" being broadly construed to encompass foreign corporations.[11] Assuming he has such jurisdiction, the unresolved question is what law will he attempt to apply to the internal affairs of a foreign corporation: New York law or the law of the state of incorporation of the foreign corporation?

In May, 2005, the Massachusetts Attorney General likewise introduced legislation to strengthen internal controls of not-for-profit organizations—"An Act to promote the Financial

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[9] Attorney General's Legislative Program Bill #68-05, Sections 4 and 5.
[10] The new Section 727 would not be applicable to religious corporations. Attorney General's Legislative Program Bill #68-05, Sections 6 and 7.
[11] *See* "The Regulatory Role of the Attorney General's Charities Bureau," July 15, 2003, available at http://www.oag.state.ny.us/charities/role.pdf.

Integrity of Public Charities," which would amend Chapter 12 of the Massachusetts General Laws. Similar in many respects to the California approach, it provides for certifications by officers of financial statements; entities required to have audited financials (those organizations with over $5 million in assets or over $500,000 in annual revenues) would be required to have an audit committee of three or more individuals who may not be employees, a majority must be board members and be independent, and (unlike New York's proposed legislation) they may not receive compensation for service on the audit committee (but unlike California, the proposed legislation would permit another committee of the board, such as the finance committee to perform the audit function); whistle blower provisions; and a prohibition against excess benefit transactions within the meaning of section 4958 of the Internal Revenue Code, including the power in the Massachusetts Attorney General to, among other things, remove officers and directors who engage in such transactions.[12]

Given these potential developments in the statutory law, and other states have legislation pending, not-for-profit corporations are going to be faced with an increasing number of requirements in different states. The problem may be also more acute, given what seems to be the inclination of some offices of the state attorneys general to assert broad jurisdiction—such as solicitation through print ads in publications, or solicitation by any means—and the advances in technology where an organization is arguably present in every state via its website on which it may solicit contributions. It is, therefore, appropriate to review the Internal Affairs Doctrine, how it has evolved and to ask what should be its application to charitable entities going forward.

## 2. <u>The Internal Affairs Doctrine</u>

### a) <u>What is the Internal Affairs Doctrine and how does it fit within traditional conflicts of law principles</u>?

The Internal Affairs Doctrine is actually a special exception to traditional conflicts of law principles. To grossly generalize, current conflicts of laws principles generally attempt to determine which state has the greatest interest in regulating the behavior in question, and then allow that state to provide the governing law for the behavior. Indeed, as the

[12] An Act to Promote the Financial Integrity of Public Charities, Sections 3(g), 4(a).

Restatement (Second) on Conflict of Laws maintains, each issue should be determined by the law of the state which has the "most significant relationship" with the issue at hand.

When one or more states have an interest in the issue in question, the Restatement (Second) lays out several factors in Section 6 which ought to be considered by courts in deciding which jurisdiction's law to apply:

1) The needs of interstate and international systems;
2) The relevant policies of the forum;
3) The relevant policies of other interested states and the relative interests of those states in the determination of the particular issue;
4) The protection of justified expectations;
5) The basic policies underlying the particular field of law;
6) Certainty, predictability and uniformity of result; and
7) Ease of determining and applying the law.

The Internal Affairs Doctrine, strictly applied, however, engages in no such balancing of factors; it does not weigh each state's underlying interests in or concerns about the matter at hand. Instead, it offers a bright line test--the law of the state of incorporation should apply to any issue related to a corporation's internal affairs. This is not to say that the Internal Affairs Doctrine does not address any of the Restatement factors; indeed, it speaks to a number of the enumerated concerns, such as the protection of justified expectations; certainty, predictability and uniformity of result; and the ease of determining and applying the law. However, it does not ask a court to consider these factors on a case-by-case basis: it merely applies the mechanical rule to all fact patterns.

In this approach, the Internal Affairs Doctrine seems to be driven largely by practical concerns. Since a corporation can operate in many different jurisdictions at once, without an Internal Affairs Doctrine to fix the law that applies, a corporation could be faced with great uncertainty about which jurisdiction's laws should govern its internal governance. Indeed, in the absence of an Internal Affairs Doctrine, a corporation would have to engage in an analysis

of which state has the "most significant contact" to the specific governance matter at hand, and could conceivably have to alter its governance structures with each new jurisdiction it enters to do business. Corporations would have to monitor each state's laws and arguably comply with the most restrictive jurisdiction in which the corporation operates. Such a regime would be highly costly and somewhat tentative, perhaps not chaotic, but certainly complicated.

The Internal Affairs Doctrine solves this problem by fixing in advance the state whose legal regime the corporation must abide by in its internal matters, providing a fixed set of rules for its internal governance. The Internal Affairs Doctrine does not extend, however, to a corporation's dealings with third parties. In such matters, the same choice of law principles that are applied to individuals are applied to the corporation's actions, and a corporation may well subject itself to the laws of another jurisdiction through such activities. (*See* Restatement § 301.) The question is – to what degree.

Corporations clearly rely on the Internal Affairs Doctrine, selecting their states of incorporation in large part based upon an assessment of their corporate governance laws. Indeed, reliance on the Internal Affairs Doctrine explains the phenomenon of Delaware, whose chief distinction as the most popular state in the federal marketplace for corporate charters depends in a large part on the perceived desirability of its corporate governance laws. While Delaware's corporate law, and the expertise and sophistication of its courts, make sense for for-profit corporations, the same may not be so for not-for-profit corporations. The latter seem to be drawn to it mainly for the ease of its incorporation/dissolution process and perhaps by the fact that its regulatory scheme for not-for-profits is largely absent.

The Internal Affairs Doctrine is not without its detractors: "Fixed, single-factor, content-blind, forum-neutral rules are supposed to be particularly obnoxious because they defer automatically and totally to one legal system in disregard of the interests and policies of the other states of contact. The [internal affairs rule] is precisely such a rule."[13] Indeed, the Internal Affairs Doctrine's mechanical test allows a corporation to seek out a state with the loosest regulation of internal corporate matters to incorporate in, all the while conducting its business in another state. This practice arguably deprives states with a legitimate substantial interest in

[13] Jack L. Goldsmith III, *Interest Analysis Applied to Corporations: The Unprincipled Use of a Choice of Law Method*, 98 Yale L. J. 597, 599 (1988).

regulating certain behaviors from having any ability to regulate the problem. Because of such concerns, state courts from time to time reject the Internal Affairs Doctrine and apply the laws of the forum state.

b) Can state regulation of the internal affairs of foreign corporations be unconstitutional?

There are several constitutional provisions which are implicated when a state attempts to regulate the internal affairs of foreign corporations: the Due Process Clause of the 14th Amendment, the Full Faith and Credit Clause and the Commerce Clause.[14] Below, in the brief discussion of the cases that follow, it is important to note that none of the cases discussed (nor any others we have found) involve not-for-profits, rather they all concern for-profit companies engaged in commerce. It may be that the application of some of these concepts to the nonprofit arena is less or more persuasive depending on the context.

Due Process Clause and the Full Faith and Credit Clause[15]: The Due Process Clause of the 14th Amendment is concerned with protecting individuals against procedural unfairness. By contrast, the Full Faith and Credit Clause is generally used to balance opposing state interests and to ensure that states respect and do not unduly impose upon the interests of other states.[16] In a series of Supreme Court cases analyzing the basic contours of legislative jurisdiction, *Allstate Insurance Co. v. Hague,*[17] *Phillips Petroleum Co. v. Shutts*,[18] however, these two constitutional concerns are treated as one and the same and are seen as the animating issues in defining the limits of the extraterritorial application of a state's laws.

[14] The Supreme Court has made clear, however, that to be a constitutional choice of law issue, there must be a "true conflict" between the law of the state being challenged and the law of another state. "If the laws of both states relevant to the set of facts are the same, or would produce the same decision in the lawsuit, there is no real conflict between them." R. Leflar, American Conflicts Law 93, p. 188 (3d ed. 1977). See also E. Scoles & P. Hay, Conflict of Laws 2.6, p. 17 (1982) ("A 'false conflict' exists when the potentially applicable laws do not differ").
[15] U.S. Const., art. IV, § 1. The Clause states: "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof."
[16] Richman and Reynolds at 283.
[17] 449 U.S. 302 (1981) (plurality opinion).
[18] 472 U.S. 797 (1985).

*Allstate* established the basic test for whether an application of a state's laws to an issue is constitutional. As it explains: "[F]or a State's substantive law to be selected in a constitutionally permissible manner, that State must have a significant contact or significant aggregation of contacts, creating state interests such that choice of its law is neither arbitrary nor fundamentally unfair."[19] Thus, a more than de minimis relationship must exist between the state in question and the party or transaction. Such a relationship may be established by looking at one factor or aggregating a combination of factors (e.g., whether the plaintiff works in the state, whether a party resides in the state, where the party is doing business). If there is not significant contact with the state after such aggregation, application of the state's law to the case is unconstitutional because it is arbitrary, unforeseeable and unfair under the Due Process and Full Faith and Credit Clauses.

The *Allstate* test was confirmed by *Phillips*, in which the Court rejected the Kansas court's application of Kansas law to a case because it found that the various contacts between the facts of the case and Kansas, even when aggregated, were not significant enough to allow a Kansas court to properly apply Kansas law to all issues in the case.[20] *Phillips* also introduced the notion of surprise and parties' expectations into the analysis. As it states, "When considering fairness in this context, an important element is the expectation of the parties."[21]

The upshot of these cases seems to be that there must be some baseline of minimal contacts with a state in order for the state's application of its law not to be arbitrary and fundamentally unfair. The Court establishes a pretty low constitutional bar: so long as a state can establish some kind of significant contact with an issue, it will not unfairly surprise a party and thus will not be seen to result in a constitutional violation.

<u>The Commerce Clause</u>[22]: Another constitutional provision that might present problems for the regulation of the internal affairs of foreign corporations is the Commerce

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[19] 449 U.S. at 312-13.

[20] Indeed, 99% of the leases at issue in the case and 97% of the plaintiffs had no relation whatsoever to the State of Kansas. Moreover, other states such as Texas and Oklahoma had a conflicting interest in the issues at hand, and the application of their laws to the issue would yield a different result. 472 U.S. at 816-7.

[21] 472 U.S. at 822.

[22] U.S. Const., art. I, § 8, cl. 3. It states in pertinent part that "Congress shall have Power…[to] regulate Commerce…among the several States."

Clause. The Commerce Clause gives Congress the exclusive power to regulate commerce among the states, and is also viewed as restricting the power of the states to regulate interstate commercial activity on a more than incidental or indirect basis, even when Congress has not sought to regulate the activity. (This restriction against state regulation of interstate commerce is known as the "dormant" or "negative" Commerce Clause.) As the Supreme Court itself has said, however, "Not every exercise of state power with some impact on interstate commerce is invalid."[23] If a state statute "regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental…unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits," it must be upheld.[24] In any constitutional analysis under the Commerce clause, there may be an issue of whether a particular not-for-profit entity is engaged in interstate commerce.

Several Commerce Clause cases specifically affirm the Internal Affairs Doctrine, albeit in dicta, and are worth mentioning. In *Edgar v. MITE Corp.*, the plurality Court references the doctrine in passing, describing it as a "conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs…because otherwise a corporation could be faced with conflicting demands."[25] The Court then goes on to reject the appellant's Internal Affairs Doctrine argument because "Illinois has no interest in regulating the internal affairs of foreign corporations. (*Edgar* involved an Illinois statute regulating procedures to govern takeover offers involving target companies in which a certain percentage of shares were owned by Illinois residents.)

A later case, *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987), is more forceful in its endorsement of the doctrine, and argues that the doctrine's application (e.g., the regulation of the internal affairs of a domestic corporation by the state) does not violate the dormant Commerce Clause, even though it may implicate interstate commerce. As it states,

> Every State in this country has enacted laws regulating corporate governance. By prohibiting certain transactions, and regulating others, such laws necessarily affect certain aspects of interstate

[23] *Edgar v. MITE Corp.*, 457 U.S. 624, 640 (1982) (plurality opinion).
[24] *Pike v. Bruce Church, Inc.,* 397 U.S. 137, 142 (1970), citing *Huron Cement Co. v. Detroit*, 362 U.S. 440, 443 (1960).
[25] 457 U.S. at 645.

> commerce. This is necessarily true with respect to corporations with shareholders in States other than the State of incorporation. Large corporations that are listed on national exchanges, or even regional exchanges, will have shareholders in many States and shares that are traded frequently. The markets that facilitate this national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. *This beneficial free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation* (emphasis added).[26]

Despite its endorsement of the Internal Affairs Doctrine by the Court in *CTS Corp.*, the Court stops short of saying that the Internal Affairs Doctrine is constitutionally required. Indeed, it leaves open the possibility that there are "rare situations" in which the application of another state's laws to a corporation's internal affairs may be necessary and desirable.

In looking briefly to federal and state court cases, interpreting the applicability of the Internal Affairs Doctrine in California, New York and Massachusetts, the only ones found are again in the for-profit business context. Of the three states briefly discussed in this paper, California has probably departed the most sharply from the Internal Affairs Doctrine in the for-profit business context.

<u>California</u>

As mentioned above, California's GCL Section 2115 determines which foreign (for profit) corporations transacting business in California are subject to California's corporate laws. Its mathematical formula used to make the determination (property, payroll and sales ratios) is borrowed from several states' (including California) tax law.[27] While expressly *not applicable* to nonprofit corporations pursuant to NCL Section 6910, the analysis of the law by the California courts is interesting. *Louisiana-Pacific Resources, Inc.*, 138 Cal. App. 3d 216 (1982) upheld as constitutional Section 2115 of the California Corporations Code and makes it

[26] *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 90 (1987).
[27] See CA Revenue and Taxation Code Sections 25129, 25132 and 25134 for a discussion of the property, payroll and sales factors.

clear that California will look at activities of foreign corporations in California: "[T]he Internal Affairs Doctrine] has never been followed blindly in California…;"[28] (imposing California cumulative voting law on a Utah corporation, where the entity's business is located in California and more than 50% of its shareholders are California residents); see also *Nedlloyd Lines B.V. v. Seawinds Limited*, 3 Cal. 4th 459 (Sup. Ct. Cal. 1992) (choice of law clause upheld to govern breach of contract claim, and extended to internal affairs (e.g., directors' fiduciary duties)); *Valtz v. Penta Investment Corporation*, 139 Cal. App. 3d 803 (Cal. Ct. Appeals 1983) (inspection of shareholder list is not an internal affair, and no real conflict because Delaware law would permit copying of Delaware corporation's shareholder list (albeit for a limited purpose) while California law permits copying of shareholders list for any purpose; finds application of California law to be constitutional).

New York

New York courts have a perhaps somewhat more mixed approach. When faced with the question of whether to apply the laws of the state of incorporation or New York law, some courts have applied the law of the state of incorporation. See *Graczykowski v. Ramppen*, 101 A.D.2d 978 at 978 (Sup. Ct. NY 1984) (following Internal Affairs Doctrine and applying law of state of incorporation to determine whether a shareholder qualified to bring suit in derivative action); *Polar International Brokerage Corp. v. Reeve*, 187 F.R.D. 108 (SDNY 1999) (following Internal Affairs Doctrine and applying law of Great Britain to matters of fiduciary duty because it found insufficient contacts with New York State to warrant the application of New York law); *Black v. USA Travel Authority, Inc.*, 2001 U.S. Dist. LEXIS 9297 (applying a strict interpretation of the need to follow Internal Affairs Doctrine and applying law of state of incorporation (in this case, New York) to determine plaintiff's forced sale of stock claim).

Other courts have looked past the Internal Affairs Doctrine choosing instead to balance the interests of New York against the interests of the state of incorporation. See *Stephens v. National Distillers and Chemical Corp.*, 1996 U.S. Dist. Lexis 6915 (SDNY 1996) (declining to apply Internal Affairs Doctrine to determine fiduciary standards where all relevant events took place in New York (it involved a reinsurance issue); *Greenspun v. Lindley*, 36 N.Y.2d 473 at 477-478 (NY Ct. App. 1975) (rejecting automatic application of Internal Affairs

[28] 138 Cal.App.3d at 324.

Doctrine in case of significant New York contacts)(noting, however, "the pragmatic as well as theoretical advantages" of the application of one law rather than leaving it to the choice of forum or several courts deciding in which state the REIT in question is present); *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 at 262-264 (2nd Cir. 1984) (rejecting use of Internal Affairs Doctrine in matter of corporate governance of foreign corporation where public policy of New York (protection of New York's right to apply New York business law to a corporation doing business in New York) weighed in favor of application of New York law.)

Massachusetts

Massachusetts courts seem generally to adhere to the Internal Affairs Doctrine. See *Beacon Wool Corp. v. Johnson*, 331 Mass. 274, 279 (1954) (looks to Delaware law to determine director's liability).

In 1997, however, the Supreme Judicial Court of Massachusetts appeared to depart from this general rule in *Demoulas v. Demoulas Super Markets, Inc.*, 424 Mass. 501, 511 (1997) in applying Massachusetts law to a Delaware corporation, although this departure from the general rule may be explained by the circumstances of the case involved (applying Massachusetts law to issues of fiduciary duties involving a Delaware corporation that later merged into a Massachusetts corporation).

In *Harrison v. Netcentric Corp.*, 433 Mass. 465, 470 (2001), the Supreme Judicial Court reaffirmed the general rule that the state of incorporation dictates the choice of law regarding the internal affairs of a corporation and confined *Demoulas* to its facts. (*Harrison* involved a closely held Delaware corporation with its offices in Massachusetts.) *Harrison* has since been followed by several courts. See e.g. *Clemmer v. Cullinane*, 2002 Mass. Super. LEXIS 248 (2002); *Kroutik v. Momentix, Inc.*, 2003 Mass. Super. LEXIS 112 (2003); *Lending4All, Inc. v. Hill*, 2003 Mass. Super. LEXIS 481 (2003).

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All this brief summary shows is that different states have departed more or less from a strict application of the Internal Affairs Doctrine in the context of for-profit business corporations. The context in which for-profit corporations operate, typically having shareholders in many states, and the emphasis by courts on the "free market system" is quite different from

that in which nonprofits operate. They do not have shareholders and are generally guided by values other than the "free market system." These differences raise the possibility that regulation of nonprofits by states other than their states of incorporation may be possibly more defensible, particularly given the emphasis on the "public trust," and the perception that nonprofits, lacking shareholders, are not accountable to anyone other than overburdened state attorneys general.

**3. Possibilities for Going Forward**

How to think about the Internal Affairs Doctrine in the context of not-for-profit charitable entities.

In looking at the regulation of the internal affairs of charitable entities, there is clearly a great interest in protecting the use of charitable assets for the public good. Moreover, not only are charitable assets involved, but there are generally members of the public who are donors or potential donors to organizations who should be protected, and there are often particular state benefits for which charitable entities are eligible (e.g., various state tax exemptions). All of these issues give a state within whose borders a charity operates an interest in regulating the behavior of the entity. And it is generally recognized that states have a right to regulate charitable entities, often arising from a charity's solicitation of charitable contributions within a state or from holding charitable assets within the state. Assuming that a state has jurisdiction to regulate a charity which is operating or doing business within its borders, is a state entitled to abrogate the Internal Affairs Doctrine and apply its law governing the internal affairs of a not-for-profit corporation to a foreign not-for-profit corporation?

Whether or not abrogating the Internal Affairs Doctrine is a positive or negative phenomenon appears to be a question of weighing various priorities. Below, are several options as to how to approach this issue.

**a) Maintaining the Internal Affairs Doctrine:**

A likely possibility going forward is a challenge on the basis of the Internal Affairs Doctrine to the California Attorney General's interpretation of the reach of the California Nonprofit Integrity Act in its regulation of the internal affairs of foreign corporations. Given his position (that the USTCPA applies to all charities doing business in California where doing

business is very broadly defined), it appears that there could potentially be a constitutional challenge under the due process, and full faith and credit clauses, to the statute's application to a foreign corporation. The threshold question would first be whether or not there is a true conflict between California's internal affairs requirements for foreign corporations and the requirements of the law of the corporation's state of incorporation. California's statute contains affirmative obligations (such as the mandatory audit committee for an entity with gross revenues of $2 million or more). It is quite possible that the statutes of the state of incorporation may be silent on this issue (e.g., Delaware). Is there a conflict? A constitutional challenge to the statute might have to wait until an actual conflicting statute (e.g., a statute which does not require a not-for-profit entity to have an audit committee unless the entity has revenues of over $5 million (e.g., Massachusetts' proposed legislation), rather than California's $2 million) exists.

Assuming a real conflict, a court would have to assess whether the contacts between the foreign corporation in question and the State of California are significant enough not to be unfair and arbitrary. Here, there are potential arguments that California's assertion of jurisdiction over the internal affairs of a foreign corporation is unforeseeable and unfair. California's desire to sweep in an entity that merely engages in fundraising in California (which, without any numerical minimum thresholds, could potentially be engaging only in de minimis fundraising within the state, i.e., one letter to a California donor, a radio appeal from outside California, a website request for contributions) does not necessarily establish a significant enough contact between the organization and the state. On the other hand, California may say that by doing any business in California, especially fundraising – which it can argue must be regulated in order to protect California donors – a foreign corporation is opting to act within the state, and thus cannot argue that it is "unfairly surprised" by the application of California law to it.

The California Attorney General's position could also be analyzed under the Commerce Clause framework. Assuming for purposes of this discussion that the regulation of the internal affairs of foreign not-for-profit corporations is a regulation of interstate commerce, one has to explore the local public benefit that is meant to be achieved by such regulation, and evaluate whether it outweighs the burdens imposed on interstate commerce. The California Attorney General would likely argue that the local benefit is protecting California donors from

nonprofit misfeasance due to poor or lax corporate governance. The burden on interstate commerce is harder to quantify, but it could be argued that nonprofits might be reluctant to do business or fundraise in California given California's internal affairs requirements, thus quashing interstate nonprofit activity. Whether a court would find that one outweighs the other is difficult to say absent specific facts as to the extent of fundraising by a foreign corporation in California and the harm involved.

Going beyond the constitutional arguments, the real question seems to be whether regulating a foreign corporation's charitable solicitations or other activities requires the application of the local state's laws to the internal affairs of a foreign corporation. This paper only looks at some of the recently enacted or currently pending state legislation, and focuses on specific provisions regarding audit committees. Looking solely at the solicitation argument, it is not clear, other than arguably being a "best practice," that audit committees are effective in protecting the public against solicitation abuses. Is it necessary to make foreign corporations comply with the local state's audit committee requirements, or should an Attorney General have to look to the state of the entity's incorporation, and not penalize a foreign corporation solely for failure to comply with the local state's audit committee requirements? I would argue that the solicitation rules, which are meant to protect donors in a state, and with which a foreign entity must comply, should not also give regulators the right to determine how the entity is internally organized, absent other relevant facts.

**b) Applying Traditional Conflicts of Law Principles**:

A more radical move would be to scrap the Internal Affairs Doctrine entirely, and instead apply traditional conflict of laws principles to matters of internal corporate governance. The advantage of such an approach would be to create a more democratic application of the law: the state with the regulatory authority over a corporation's internal governance would be the state which had the most significant contact with or was most affected by such governance matters.

In many cases, this is an easy determination. For the entity which is incorporated in one state (for instance, Delaware) but chooses to operate in another state (for instance, New York), so that all its contacts are in the second state, the abrogation of the Internal Affairs Doctrine does not seem unreasonable. There should not be confusion and surprise in the

application of the law of the local state to the entity's internal affairs. However, the question remains as to whether it is necessary. Most state laws have provisions which regulate the internal affairs of entities incorporated in them. It does not seem unduly onerous for a state to look to the state of the entity's incorporation for the governance of that entity's affairs.

The question is much more difficult when an entity operates and has offices in several states. In that situation, if there are conflicts between the laws governing the internal affairs of corporate entities in each state, it seems unreasonable for an entity to have to stay abreast of all laws of the states in which it operates, even if not in conflict, and to comply with the most stringent set of laws of the states in which it is present. In this situation, despite the perhaps persuasive need of each state to regulate charitable behavior for the benefit of the public, it does not seem unreasonable for each state to look to the law of the entity's state of incorporation, thereby following the Internal Affairs Doctrine. And in both situations, looking again at the solicitation issue, if the organization is a fundraising entity, it may well inadvertently – for instance, through an appeal on its website – become subject to the jurisdiction of other states, and the attempt by those states to regulate its internal affairs.[29] There could be a real difficulty in identifying which state has the most significant contacts, and that determination might change according to a corporation's activities, thus generating too much uncertainty and instability to sustain corporate activity.

**c) A Hybrid System: Allowing both the state of incorporation and states in which the corporation maintains a certain level of activity to apply each other's laws.**

Another possibility would be to allow a hybrid of the Internal Affairs Doctrine and more traditional choice of law principles. Generally, the law of the state of incorporation would govern a corporation's internal affairs. However, if it could be shown that another state had more significant contacts or was more deeply affected by a certain internal corporate issue, it could apply its own law governing internal affairs. In a true hybrid system, in a case where the only contact a corporation had with a state was its incorporation in that state, the incorporating state might look to the law of the state where the corporation carried on its activities.

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[29] While not expressly relevant, the "Charleston Principles: Guidelines on Charitable Solicitation Using the Internet," approved by the National Association of State Charity Officials on March 14, 2001, attempt to deal with the ease of an entity's reach into a state via technology and the jurisdiction of State Attorneys General over domestic and foreign entities.

The Restatement (Second) even seems to contemplate this sort of regime. Indeed, as it states in § 302(2):

> The local law of the state of incorporation will be applied to determine such issues, except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which event the local law of the other state will be applied.

Certain states have begun to apply this type of balancing or quantitative test, applying their regulation of corporate governance matters to what some have termed, "pseudo-foreign" corporations. For instance, California's business corporations statute regulates certain aspects of governance of a foreign corporation when the corporation's business in California exceeds one-half of its total activities and more than one-half of the company's stock is held by Californians. (Cal. Corp. Code § 2115(a) (West 1990).[30] As noted above, New York's N-PCL provisions regarding, for instance, liability of directors and officers of foreign corporations also provide an exemption from the application of New York law under § 1321 for charities whose principal activities are conducted outside the state, the greater part of their property is located outside the state, and less than ten percent of their revenues are derived from solicitation of funds within the state.[31]

This type of combination rule preserves in most circumstances the stability offered by the Internal Affairs Doctrine, but also begins to address the issue of "pseudo-foreign corporations." It still, however, does not provide certainty or stability to the entity operating in several different states.

**d) Uniform federal governance regulation**:

A final solution would be to move wholesale from state-based regulation of the internal affairs of corporations to a unitary federal system. We may be moving in this direction given proposals to create federal "best practices" for board governance, and a federal right of

[30] There is a line of California cases which have upheld this approach.

[31] New York's Business Corporation Law also contains a provision which carves out from its regulation of certain internal affairs a foreign corporation for whom "less than one-half of the total of its business income for the preceding three fiscal years, or such portion thereof as the foreign corporation was in existence, was allocable to this state for franchise tax purposes under the tax law." (*See* New York Business Corporation Law § 1320(a)(2)).

action authorizing the IRS to sue to remove board members for breach of fiduciary duty. While the areas of conduct are limited, in effect, such laws aim to federalize certain aspects of the law of corporate governance and oversight of non-profits.

The advantages of a federal system are obvious: it would provide consistency, efficiency, and eliminate the ability of corporations to shop for the most permissive regulatory regime for their corporate charters. The disadvantages or obstacles are significant and not to be minimized, however. One may be the political difficulty of trying to enact such a system. By essentially pre-exempting state regulation of certain areas of corporate governance it would be a substantial overhaul of corporate law, eliminating state authority over many areas the states have had for centuries. It would do away with the ability of states to experiment with different regimes. Moreover, depending on the form the proposed legislation may take, it could prove onerous for certain organizations. The not-for-profit arena is justly celebrated for its diversity, its breadth of organizations, from large to very small. To apply a one-size fits all federal governance scheme could potentially restrict this diversity and in some cases the quirkiness of the nonprofit field which constitutes one of its significant strengths.

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On balance, I think the Internal Affairs Doctrine has much to recommend it: certainty and predictability being foremost. The contacts with a state other than the entity's state of incorporation, and the behavior sought to be regulated by the internal governance rules or standards of the local state should have an immense impact on the local state before the local state imposes its own governance standards on the foreign entity.