

Exit and the American Illness

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Other chapters of this book extensively document problems created by regulatory, liability, and litigation inefficiencies in American law. Some of those inefficiencies are found in federal law, others in state law. Indeed, one who locates or conducts business in the U.S. could be exposed to the maladies of many jurisdictions within the U.S., compounding the problems of American law. Moreover, state laws that regulate business activities located elsewhere may not be subject to the same disciplinary pressures as are state laws whose ill effects are experienced only locally.

Multiple jurisdictions could mitigate inefficient regulation, however, if they enable firms to avoid excessively high liability states and select states with more efficient laws. In other words, adopting Albert O. Hirschman’s framework, the U.S. offers the potential of “exit” to offset the excesses of “voice,” or the political system.¹ Permitting the parties to choose the state whose laws govern their contract, and to exit unfavorable states, would allow them to select a set of laws better matched to their needs. By contrast, legal reforms are less likely to provide an optimal set of laws, since governments lack the knowledge of the parties as to their individual needs. Moreover, if parties can choose their governing laws, they can better predict the legal

¹ See Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses To Decline In Firms, Organizations, and States* (1970).

consequences of their conduct, and firms conducting business in multiple jurisdictions can formulate a single corporate policy to comply with a single governing law.

Party choice serves another purpose, in disciplining states with inefficient laws. A state which finds that people within it routinely exit from its laws, choosing instead to be governed by the laws of another state, will have an incentive to amend its laws to mimic the laws of the favored state.²

Exit from undesirable laws could occur in at least three ways. First, the firm might avoid doing business in problematic states and choose another, more benign jurisdiction to govern its activities. It might incorporate in the other jurisdiction; it might decide not to locate assets, advertise or conduct business in problematic states; and it might through a choice-of-law clause in its contracts specify that the law of another state is to apply. Second, parties might by contract, through a choice-of-court clause, choose a court in another U.S. state to hear disputes, at least regarding legal issues that arise out of private contract. Third, parties can opt out of litigation within U.S. courts altogether by choosing either private arbitration or courts outside of the US. The second and third forms of exit both enable firms to avoid problematic litigation rules and enhance the likelihood that courts will apply the parties' chosen law in resolving disputes.

Exit from the U.S. jurisdictions most plagued by legal maladies can help at least partially to restore U.S. competitiveness. U.S. law does help facilitate exit. Although states may resist exit efforts by national firms, the U.S. Constitution, Congress and the federal courts can limit state efforts to impose their laws on firms. The dormant commerce clause directly restrains the states from discriminating against interstate and in favor of intrastate commerce, while the

² On jurisdictional competition, see Erin O'Hara and Larry Ribstein, *The Law Market* (2009).

positive commerce clause and the supremacy clause enable the federal government to override state legislation that burdens national and international firms. The U.S. system potentially enables firms and individuals to choose to be governed under any legal regime while maintaining the ability to conduct business (or not) anywhere else. This allows parties to pressure states to maintain reasonable laws in order to retain franchise fees, taxes, jobs, litigation, arbitration, and other opportunities.

Party choice-of-law in the U.S. is imperfect, however. To some extent, this is not unreasonable. Unlimited party choice can result in a race to the bottom in which third parties are harmed. It might also be abused by a party with oppressive bargaining power. To address these problems, exit options could be limited by the states in sensible ways.³ Even taking such objections into account, however, the current limitations on party choice are excessive and vague. The problematic political forces that make a state inhospitable to business might carry over to the state's choice-of-law regime, and block the possibility of exit. These restrictions on party choice plausibly make interstate and international contracting parties wary of engaging in cross-border trade in the US.

Choice-of-law in the US

The starting point: personal jurisdiction

Jurisdictional choice begins with physical mobility. Unless a state can compel a party to enter its courts, those courts cannot enter judgments that affect it. Personal jurisdiction rules

³ We explore this topic elsewhere. Erin A. O'Hara & Larry E. Ribstein, *id.*

therefore provide a basis for jurisdictional choice in the US, albeit a narrow one. Under the Due Process clause of the U.S. Constitution, courts may assert jurisdiction over defendants who have had only “minimum contacts” with the state, so long as defendant directs enough action toward the forum to make it fair that the defendant be sued in that state.⁴ Thus, for example, due process is satisfied where the defendant knows it is making sales in or otherwise directing sales activity into a state.⁵ Although the test ensures that a defendant has fair notice that it will be subject to the state’s law, firms that depend on national advertising and distribution systems have difficulty avoiding burdensome state laws. Nevertheless, firms have some ability to avoid burdensome state laws by avoiding even minimum contacts with the state, and this possibility helps to constrain states’ ability to impose their laws on firms based in other states.

It is not clear, however, how actively firms must avoid contacts with states or what constraints are imposed on a firm’s ability to structure itself and its activities in order to avoid personal jurisdiction in a particular state. In two cases currently pending in the U.S. Supreme Court, state courts have interpreted their jurisdictional authority quite expansively by asserting personal jurisdiction over companies whose products ended up in the forum even though the defendant entity did not choose to sell any of its goods in the state. In *Nicastro v. McIntyre Machinery America, Ltd.*,⁶ New Jersey state courts asserted personal jurisdiction over a British

⁴ World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297 (1980).

⁵ Asahi Metal Indus. Co. v. Superior Ct., 480 U.S. 102, 111-12 (1987).

⁶ 201 N.J. 48, 987 A.2d 575 (2010), cert. granted J. McIntyre Machinery Ltd. V. Nicastro, 113 S. Ct. 62 (Sept. 28, 2010).

manufacturer of a recycling machine that injured a scrap metal worker in New Jersey. The manufacturer commissioned another company with the same name but otherwise independent to act as its exclusive U.S. distributor. The distributor sold the machine to the plaintiff's employer in New Jersey. The New Jersey Supreme Court held that it could be sued in New Jersey even if it did not purposely avail itself of a New Jersey market or was, as it claimed, unaware that its product was sold in the state. Instead, it was sufficient that defendant commissioned a distributor to market the product throughout the U.S. Defendant either "knew or reasonably should have known that its distribution scheme would make its products available to New Jersey consumers," and this availability created a strong presumption in favor of the exercise of personal jurisdiction over the defendant.⁷ The New Jersey court's conclusion would prevent a company from attempting to shield itself from liability by simply outsourcing its distribution, but it does so in a way that makes it impossible for firms to avoid personal jurisdiction everywhere without strong control over all product distribution and steadfast avoidance of undesirable states.

On the same day that the Supreme Court granted certiorari in *Nicastro*, it also granted certiorari in *Brown v. Meter*,⁸ a personal jurisdiction case originating from the state courts of North Carolina. Here subsidiaries of defendant Goodyear Tire. Co. manufactured tires that were sold in North Carolina. As in *Nicastro*, the manufacturers did not handle tire distribution in the U.S. Instead, they "used their Goodyear parent and affiliated companies to distribute the tires

⁷ 201 N.J. at 79, 987 A.2d at 593.

⁸ 681, S.E.2d 383, cert. granted *Goodyear Luxembourg Tires, S.A. v. Brown*, 131 S. Ct. 63 (Sept. 28, 2010).

they manufactured to the United States and North Carolina.”⁹ According to the North Carolina court, personal jurisdiction could be based on defendants’ purposefully injecting their product into the stream of commerce without attempting to exclude North Carolina as a potential product market.¹⁰ This decision would prevent companies from strategically organizing their manufacturing and distribution systems in order to avoid liability for injuries caused by the use of their products in a particular jurisdiction. Even if this goal makes sense, the North Carolina court achieves it in a way that sharply inhibits firms from controlling where they might be sued. The tire that allegedly caused plaintiffs’ injuries never entered the forum state of North Carolina, but was instead manufactured in Turkey and sold in France, where the fatal injury occurred. The North Carolina courts used the fact that *some* tires manufactured by defendant made their way into North Carolina in order to exercise general jurisdiction over the Turkish defendant. Under this ruling, the Turkish defendant must defend any lawsuit based on any claim in North Carolina courts.

A court’s ability to reach a defendant’s conduct based on local distribution by a separate, albeit affiliated, entity, broadly extends its reach. Combined with a court’s broad power, discussed below, to apply local law, this frustrates a firm’s jurisdictional choice. The U.S. Supreme Court’s grant of certiorari may be intended to discipline these exercises of state jurisdictional authority. In the meantime, this potential jurisdictional reach must trouble firms contemplating doing business that might involve any contact with the United States.

⁹ Id. at 386.

¹⁰ Id. at 391.

Jurisdictional choice and conflict of laws

Because states can broadly exercise personal jurisdiction over firms, parties often have no choice but to comply with a state's procedural litigation rules. At least in theory, however, parties might be able to avoid state substantive regulatory and liability rules because state conflicts of law rules sometimes direct a court to apply foreign substantive law. If conflicts of law rules are clear (i.e., the law of the place of sale or manufacture, or injury applies to product liability claims), parties may be able to fashion their conduct to avoid the application of undesirable laws.

Under the principle of party choice, discussed above, contracting parties could avoid undesirable laws by choosing more the laws of more favorable states in their contracts. Effective exit from undesirable laws requires that parties be permitted to determine which law will apply to their actions *at formation* of the contract. If instead jurisdictional choice is effectively made by plaintiffs at the time of suit by choosing the court, manufacturers and other potential defendants must comply with the laws of all states that could exercise jurisdiction over them. We therefore distinguish consensual *party choice* (where parties specify the law to govern the contract *ex ante* at formation) from non-consensual *state conflicts law* (where the governing law is specified *ex post* at the time of trial).

US courts have used several different approaches to resolve conflicts of law law issues. Under each approach, courts focus on the state authority to regulate rather than on facilitating party choice or predictability. Unfortunately, U.S. law reflects a distinct trend away from relatively clear rules towards vague standards. This makes it much more difficult for parties to predict the governing law at the time they engage in the relevant conduct or transactions, and

therefore to choose where to locate their assets and activities based on this law. In addition, because the vague standards enhance a court's ability to apply the law of the forum state, they diminish the parties' ability to exit from undesirable state laws.

The traditional approach

Early U.S. conflicts decisions roughly reflect the vested rights or territorial approach which is embodied in the First Restatement of Conflict of Laws. Under the territorial principle, the laws of sovereign states could control only parties present and events occurring within their borders.¹¹ For cases involving people and events spanning multiple states, choice-of-law turned on "vested rights," the idea that rights vest, if at all, only at one point and place in time.¹² Specifically, the First Restatement listed rules for where rights vested based primarily on the cause of action creating a right. For example, the law of the situs of property controlled real property rights,¹³ the law of the place of injury dictated the rules governing most tort actions,¹⁴

¹¹ 1 J. Beale, A Treatise on the Conflict of Laws 6 (1935).

¹² For a history of the vested rights concept see Lea Brilmayer, Conflict of Laws 16-17 (2d ed. 1985).

¹³ Restatement (First) of Conflict of Laws §§ 214-254.

¹⁴ Id. at 377, Reporter's Notes.

the law of the place of contract determined the validity of and obligations in a contract,¹⁵ and the law of the place of performance determined both the legality and sufficiency of the parties' contractual performance.¹⁶ As long as the rules were well specified and courts everywhere agreed to follow the same rules, any party could determine what law would apply to an activity or contract at the time of engaging in or making it. Under uniform rules, parties wishing to avoid the property law of Utah could purchase property elsewhere, firms could locate their commercial activities outside of states whose tort laws imposed excessive liability, and parties could form or perform contracts outside of states where contract enforcement or regulation seemed problematic.

Unfortunately, courts did not apply the traditional approach clearly and uniformly. The underlying rationale for creating rules for vesting rights was murky under the traditional approach,¹⁷ which created problems in situations where rules were left unspecified or their application was unclear. Although simple rules always create difficulties in a world where parties and activities are increasingly mobile, the traditional rules often seemed to allocate sovereign authority arbitrarily and the absence of a clear policy framework left courts free to fill gaps and uncertainties in particular rules however they wanted. For example, since it was not

¹⁵ Id. at §§ 332-47.

¹⁶ Id. at § 358.

¹⁷ For influential criticisms of Beale's approach, see Walter Wheeler Cook, *The Logical and Legal Bases of the Conflict of Laws* (1942); Brainerd Currie, *Selected Essays on the Conflict of Laws* (1963).

clear why one law should apply to contract performance and another to contract validity, or which rules were contract (breach of warranty) and which tort (e.g., negligence), or what distinguished a procedural rule drawn from the forum and a substantive rule subject to the vested rights system,¹⁸ the courts could, and indeed had to, make their own ad hoc judgments.

Judicially-crafted escape devices that enabled courts to reach desired results further hindered uniformity and thus the parties' ability to predict results. Most importantly, courts could refuse to apply a law of another state deemed contrary to the forum's "strong public policy,"¹⁹ but courts were left on their own to determine which policies seemed strong. Adding to these difficulties, the parties were helpless to avoid the uncertainties of the traditional approach because it denied them an explicit right to contract for the law of their choice.²⁰

Only a small minority of U.S. states still apply the traditional rules-based approach.²¹ The courts have abandoned this approach for some version of the vague, standard-based, interest analysis approach discussed next. This wholesale abandonment of conflicts rules in favor of

¹⁸ See First Restatement § 585 (providing that "[a]ll matters of procedure are governed by the law of the forum.").

¹⁹ See First Restatement § 612 (providing that "[n]o action can be maintained upon a cause of action created in another state the enforcement of which is contrary to the strong public policy of the forum.").

²⁰ Lea Brilmayer, *Conflict of Laws: Cases and Materials* 312-13 (4th ed. 1995).

²¹ Symeon C. Symeonides, *Choice-of-law in the American Courts in 2005: Nineteenth Annual Survey*, 53 *Am. J. Comp. L.* 559, 595-96 (2005).

standards was unwise. While the traditional system was flawed, many of the individual rules generated under it were sensible. Moreover, by throwing out the traditional approach courts may have been committing the Nirvana Fallacy of comparing flawed rules with an idealized alternative. Because all choice-of-law systems have flaws, and multiple and irreconcilable goals, courts could never develop a perfect system for choosing the applicable law. The more complicated, less predictable approaches that replaced the traditional approach plausibly create more harm than good for interstate and international commerce.

Instead of dumping the traditional approach, the courts might have developed a logical and internally consistent way of filling the inevitable gaps in the traditional approach, and at least narrowed the “public policy” escape hatch which undermined certainty and predictability. But the states that led the movement away from the traditional approach were uninterested in predictability, and, as large states with large internal markets (New York and California in the 1950’s and 1960’s), they likely felt unthreatened by commercial pressures to provide predictability. Put differently, the movement away from the traditional approach reflected U.S. states’ preference for conflicts rules that emphasized local political and regulatory interests over consistency, predictability, and party choice.

Interest analysis

Modern conflict of laws has been shaped significantly by Brainerd Currie, who proposed his system of interest analysis in the early 1960’s.²² Interest analysis is now used in some form

²² Brainerd Currie, *Selected Essays on the Conflict of Laws* (1963).

by a majority of U.S. courts as the basis for conflicts of law decisions, and sadly has done much to reduce predictability and increase the cost of doing business.

Currie took issue with the traditional approach's strong emphasis on a single, potentially arbitrary connecting factor between the facts of a case and the state whose law applies. To justify the application of their law, said Currie, states need more than a mere connection with the case. Currie thought a state should regulate the parties and their activities only if its connection to the case triggered the policy rationales behind the state laws. If the facts of the case implicated only one state's policies, then that state's law should control the outcome of the case in order to effectuate that state's policies.²³ Suppose, for example, a contract is entered into between two individuals who live in state *X* involving subject matter and performance in state *X*. However, the contract is signed in state *Y* while the parties are vacationing there. State *Y* has a connection to the case which might be controlling under the traditional approach (as the place of contracting) but *Y* has little interest in the enforceability, duties, and performance of that contract.²⁴

Currie's identification of state interests under his proposed approach was formulaic and limited. In general, he seemed to recognize three types of state interests: states with plaintiff-favoring laws were presumed to have an interest in compensating resident plaintiffs; those with defendant-favoring laws were presumed to have an interest in protecting resident defendants; and

²³ *Id.* at 183-84.

²⁴ Currie applies a similar analysis to an example involving restrictions on married women's ability to contract. Brainerd Currie, *Married Women's Contracts: A Study in Conflict-of-Laws Method*, 25 *U. Chi. L. Rev.* 227 (1958).

states with regulatory laws were presumed to have an interest in regulating conduct within their borders. Whether a state had an interest in having its substantive law applied to a disputed issue thus turned on where the parties resided and where the relevant conduct occurred.²⁵

Currie recognized the possibility that more than one state might have an interest in regulating the matter. He proposed that courts resolve these “true” conflicts between multiple interested states by applying forum law and justified this conclusion by stating that legislatures and constituents expect courts to enforce local policies whenever they are implicated. Note that with this position on forum law, Currie effectively trumped the party choice principle.

Currie’s formulaic and limited determination of state interests, if adopted by courts, would have enabled conflicts of laws determinations to be relatively (although not completely) predictable. But courts apparently were uncomfortable with the artificiality of Currie’s conclusions. Judges thought, for example, that states sometimes have an interest in compensating nonresident visiting plaintiffs, defendant’s state sometimes has an interest in regulating defendant’s conduct wherever it occurred, and that some states have interests in compensating or protecting third parties, such as family members or medical creditors. Other tricky issues arise under interest analysis, including, among other things, the appropriate basis for determining actual legislative intent and how to infer intent from the law itself when the legislature has not expressed it.²⁶ These issues made it more difficult for parties to know the applicable law at the time of their conduct.

²⁵ See Lea Brilmayer, *Conflict of Laws* § 2.1 (2d ed. 1995) (discussing probable views of Currie based on his case analyses).

²⁶ See Brilmayer, *id.* at § 2.5.

Even worse from the standpoint of jurisdictional choice, interest analysis creates biases in favor of residents, forum law, and plaintiffs.²⁷ Currie assumed that states' policies protect only local residents and that the forum law should apply both in cases of "true conflicts" and in cases where no state had an interest in applying its law. The bias for forum law, in turn, favors plaintiffs because they are generally in the best position to choose the forum. Academics' attempts to improve on Currie's interest analysis have not solved these problems and would indeed shrink party choice further.²⁸

The Second Restatement and the UCC

²⁷ See Patrick J. Borchers, *The Choice-of-Law Revolution: An Empirical Study*, 49 *Wash. & Lee L. Rev.* 357 (1992); Michael E. Solimine, *An Economic and Empirical Analysis of Choice-of-law*, 24 *Ga. L. Rev.* 49 (1989); Stuart E. Thiel, *Choice-of-law and the Home-Court Advantage: Evidence*, 2 *Am. Econ. L. Rev.* 291 (2000).

²⁸ William Baxter, *Choice-of-law and the Federal System*, 16 *Stan. L. Rev.* 1 (1963); David F. Cavers, *A Critique of the Choice-of-Law Problem*, 47 *Harv. L. Rev.* 173 (1933); Robert A. Leflar, *Choice-Influencing Considerations in Conflicts Law*, 41 *N.Y.U. L. Rev.* 367 (1966) (advocating application of "better" law as one of five choice-influencing considerations); Elliott E. Cheatham & Willis L.M. Reese, *Choice of the Applicable Law*, 52 *Colum. L. Rev.* 959 (1952).

The Restatement (Second) of Conflict of Laws, promulgated in 1971, is the most widely used set of choice-of-law principles in U.S. courts.²⁹ Courts likely find the Restatement attractive because, by combining elements of rules, interest analysis, and other choice-of-law analyses, it only lightly constrains their determinations of the applicable law. Some argue that this flexibility better enables courts to allocate sovereign authority wisely,³⁰ though we question whether parochial judges are well-situated to exhibit the impartiality that wisdom requires. More importantly for our purposes, judicial flexibility comes at the significant price of further preventing parties' from predicting what law courts will apply to their conduct. In addition, party choice is not followed and parties find it harder to exercise the exit option.

The Second Restatement starts with general default rules for particular types of disputes which can always be overcome by another set of general factors to guide court choices. For example, if contracting parties have not agreed to the applicable law, the Restatement provides a series of default rules for different types of contracts. The law where the land is situated determines the validity of and party obligations under contracts for the transfer of interests in

²⁹ See Symeon C. Symeonides, Choice-of-law in the American Courts in 2010: Twenty-Fourth Annual Survey, 59 *Amer. J. Compar. L.* ____ (2011).

³⁰ See, e.g., Peter Hay, Patrick J. Borchers & Symeon C. Symeonides, *Conflict of Laws* (5th ed. 2010) (“for a whole generation, much of the academic literature seems to have demoted predictability to the lowest possible rank in the pyramid of conflicts goals and to have placed flexibility at the very top”).

land;³¹ the law of the state where the seller is to deliver the chattel determines the validity of contracts to sell chattels;³² the law of the state where the insured resided at the time the contract was formed determines the validity of a life insurance contract;³³ the law of the state where the insured risk is principally located during the policy term determines the validity of a contract for fire, surety or casualty insurance;³⁴ and so on. Although these default rules seem relatively clear, courts can always displace them when they prefer to apply some other law.

Section 188 provides a list of “contacts to be taken account” of, and these other states’ laws might displace the default law if one is considered to have the most significant relationship to the transaction or the parties.³⁵ Courts make that latter determination by referring to several general conflicts factors, including “the needs of the interstate and international systems;” the policies of the forum, other interested states and the field of law involved, protection of justified expectations, certainty, predictability, uniformity and ease of determining and applying the law.³⁶ The Second Restatement at least acknowledges the importance of predictability, but only as one of several relevant factors. Courts likely cannot achieve the goal of furthering a

³¹ Restatement (Second) of Conflict of Laws §§ 189-90.

³² *Id.* at § 191.

³³ *Id.* at § 192.

³⁴ *Id.* at § 193.

³⁵ *Id.* at § 188.

³⁶ *Id.* at § 6.

predictable system when predictability is just one of several relevant objectives. Not surprisingly, then, in practice this factor is largely ignored.

The basic problem with all of these judicial approaches to choice-of-law is that courts make the final decision without sufficient (or in some cases, any) discipline by rules that could cabin the exercise of judicial discretion. Moreover, courts that tend to favor plaintiffs in fashioning substantive rules often have a similar incentive to use conflicts of law rules that enable them to apply these plaintiff-friendly laws,³⁷ and plaintiffs are quite adept at finding those fora. In short, choice-of-law rules in the U.S. fails to exploit the potential of the U.S. federal system to enable parties to exit oppressive laws.

Perhaps the most important provision in the Second Restatement is Section 187(1), which explicitly authorizes the enforcement of choice-of-law clauses in contracts. The recognition of this provision in every U.S. state provides significant predictability and makes choice-of-law clauses a critical mechanism for jurisdictional choice in U.S. contractual settings. Party choice is however constrained by two exceptions in Section 187(2): (a) where the parties chose the law of a state that “has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice;” and (b) where the chosen law is “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 that state would be chosen in the absence of a choice-of-law clause.

³⁷ See Erin Ann O’Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice-of-law*, 53 *Vand. L. Rev.* 1551, 1559 (2000).

Although Section 187(2) is vague enough to enable courts to deny enforcement of choice-of-law clauses, courts have routinely enforced such clauses under the Second Restatement. Moreover, some states have adopted their own statutes providing for unqualified enforcement of choice-of-law clauses in large commercial transactions.³⁸ A search within a large contract database indicates that many parties choose from among a few major commercial jurisdictions – Delaware, New York, California, Texas and Illinois,³⁹ the very states that compete for business by passing statutes mandating enforcement of choice-of-law clauses. This indicates that there is a market for *law* separate from a jurisdictional competition to attract firms' investments or business establishments. That conclusion is strengthened by the popularity of choosing Delaware law for many different types of contracts despite the fact that relatively few firms have significant contacts with Delaware other than as a state of incorporation. Another study of choice-of-law clauses in merger and acquisition contracts confirms the existence of a national market for law dominated by Delaware and New York.⁴⁰

³⁸ See Larry E. Ribstein, From Efficiency to Politics in Contractual Choice-of-law, 37 Ga. L. Rev. 363 (2003).

³⁹ *Id.* at 434-35.

⁴⁰ See Theodore Eisenberg & Geoffrey P. Miller, Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements, N.Y.U. L. Econ. Res. Paper No. 06-31, 20 n.10 (2006), available at <http://ssrn.com/abstract=918735>.

The principle of party choice is recognized in contracts governed by the Uniform Commercial Code. The UCC has long provided for the enforcement of a clause specifying the law of any state, provided that it bear a “reasonable relation” to the transaction.⁴¹

States’ broad enforcement of choice-of-law clauses provides some cause for hope regarding party choice in the US. However, enforcement is not guaranteed for situations involving potentially unsophisticated parties such as consumers, employees, and franchisees, and fails to assist in the many cases in which contracts are impracticable. Thus, firms beleaguered by consumer and tort litigation must rely on states’ vague default conflicts of law rules as a basis for making jurisdictional choices. This, combined with the broad jurisdictional rules discussed above, enables state courts to apply oppressive local consumer and tort law to remote firms that operate nationally and have little practical ability to avoid the opportunistic states.

The question addressed next is whether federal and U.S. Constitutional law offers more promising routes to party choice. This might have the appearance of a paradox. We favor party choice and jurisdictional competition amongst U.S. states. As such, we generally view with disfavor federal substantive laws which restrict interstate competition by mandating national standards. Here, however, we argue for federal laws which would promote competition amongst states by facilitating exit from a state.

Federal Statutes

⁴¹ UCC § 1-105(1) (2001). UCC § 1-301(f). This reflects another potential problem in federal systems -- the states' ability in some situations to form a cartel through uniform laws to inhibit jurisdictional competition.

The U.S. Constitution empowers Congress to enact laws controlling conflicts of law under the Full Faith and Credit Clause, which gives Congress the power to determine the effect states must give to other states' public acts or laws,⁴² and the Commerce Clause, which enables Congress to regulate interstate and international commerce.⁴³ However, Congress has little incentive to meddle in traditional areas of state law unless interest groups demand action on a particular issue. Choice-of-law is the sort of "meta" issue on which an interest group consensus is hard to find. Thus, for example, Congress has been stirred to action on choice-of-law very rarely and recently only by the high-profile same-sex marriage issue implicated in the Defense of Marriage Act (DOMA).⁴⁴ Even there, Congress merely confirmed states' power to apply local public policy rather than other states' marriage laws.

A rare example of Congress's acting to specify choice-of-law was the National Bank Act provision enabling a bank to charge any interest rate permitted in the state where that bank was

⁴² U.S. Const. art. IV, § 1.

⁴³ U.S. Const. art. I, § 8.

⁴⁴ Defense of Marriage Act 28 USC.A. § 1738c (2007) provides that "[n]o State . . . shall be required to give effect to any public act, record, or judicial proceeding of any other State . . . respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State."

located, regardless of the usury laws in the state where the borrower resided.⁴⁵ This rule addressed specific policy concerns in response to strong interest group pressure and high inflation rates that severely limited available mortgage funds in states with fixed interest rate caps. The more usual situation is represented by the Class Action Fairness Act of 2005 (“CAFA”),⁴⁶ which responded to the problem of proliferating and burdensome state class action suits by giving the federal courts jurisdiction over large multi-state class actions.⁴⁷ Prior to CAFA, plaintiffs could choose to file class actions in state courts that would apply liability-friendly laws or that were willing to manipulate conflicts of law doctrine to arrive at a single governing law for all claims, or both, thereby making it easier to obtain class action certification. Congress could easily have gone further in resolving the problem of plaintiffs shopping for favorable substantive law or certification decisions by adopting a federal conflicts of law rule in

⁴⁵ National Bank Act, 12 USCA. § 85 (2007). In *Marquette Nat’l Bank v. First Omaha Serv. Corp.*, 439 U.S. 299 (1978), the Supreme Court determined that a bank was located in the State where it was chartered for purposes of this section.

⁴⁶ Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4 (2005).

⁴⁷ Pub. L. No. 109-2, 119 Stat. 4 (2005), section 4 of the Act provides that federal courts may exercise diversity jurisdiction over any class action in which “any member of a class of plaintiffs is a citizen of a State different from any defendant” so long as the claims aggregated total more than five million dollars.

CAFA to govern complex litigation.⁴⁸ Instead, Congress remained silent, thereby subjecting federal courts handling complex litigation to the same conflicts of law chaos present in state courts.

Federal Courts and Diversity Jurisdiction

US federal courts can hear suits based on state law, other than those covered by CAFA, only if all plaintiffs and all defendants are citizens of different states and the amount in dispute exceeds \$75,000.⁴⁹ Where “diversity” jurisdiction is present, defendants can remove cases to federal courts even if the plaintiff originally filed them in state court. Under the *Erie* doctrine,⁵⁰ federal courts must apply substantive state law in these cases. Federal courts sitting in diversity also must apply the conflict of law rules of the state in which the federal court is located.⁵¹

Federal courts, which are less subject to state courts’ incentives to attract litigation, have been more likely than state courts to enforce choice-of-law clauses. But federal courts must apply state conflicts of law rules, which can sometimes constrain federal enforcement of choice-

⁴⁸ Stephen B. Burbank, *The Class Action Fairness Act of 2005 in Historical Context: A Preliminary View*, draft manuscript available at <http://www.ssrn.com/abstract=1083785>.

⁴⁹ 28 USC. § 1332.

⁵⁰ See *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).

⁵¹ *Klaxon Co. v. Stentor Elec. Mfg.*, 313 U.S. 487 (1941).

of-law clauses. Even if federal courts could fashion their own conflicts of law rules, however, it is not clear these rules would be much clearer or more predictable than those created by state courts.⁵²

The Federal Constitution

Several constitutional provisions arguably enable courts to address the chaos of common law conflicts of law rules directly without federal statutes. These include the Full Faith and Credit Clause, which allows courts to decide the respect that each state must give to one another's laws even where Congress is silent;⁵³ the Due Process Clause,⁵⁴ which protects

⁵² See Arthur Miller & David Crump, *Jurisdiction and Choice-of-law in Multistate Class Actions After Phillips Petroleum v. Shutts*, 96 *Yale L.J.* 1, 79 (1986) (proposing federal statute to govern mass litigation in federal courts but expressing skepticism that the federal courts would ultimately do a better job than the states).

⁵³ See U.S. Const. art. IV, § 1 (“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”).

⁵⁴ See U.S. Const. amend. XIV, § 1 (“No state shall . . . deprive any person of life, liberty, or property, without due process of law . . .”).

parties from unfair surprise regarding the applicable laws; the Equal Protection⁵⁵ and Privileges and Immunities Clauses,⁵⁶ which might be applied to constrain conflicts of law approaches that discriminate in favor of state residents; and the “dormant” form of the Commerce Clause,⁵⁷ which prevents states from excessively interfering with interstate commerce.

The application of these provisions potentially could go a long way toward promoting jurisdictional choice. Indeed, the Supreme Court did start down the road of constitutionalizing conflicts of law in the late 19th and early 20th Centuries by applying the Due Process and Full Faith and Credit Clauses. The Court used the Due Process Clause in insurance contract cases to mandate application of the law of the place of contracting in determining the parties’

⁵⁵ Section 1 of the Fourteenth Amendment also provides that states may not deny any person within their jurisdiction the equal protection of the laws.

⁵⁶ Article 4, section 2 of the Constitution provides that “[t]he citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States.”

⁵⁷ See U.S. Const. art. I, § 8, cl. 3 (providing that Congress has the power “[t]o regulate Commerce . . . among the several states”). The Clause has also been interpreted to prevent state regulations of interstate commerce. The negative aspect of the Commerce Clause is often referred to as the Dormant Commerce Clause. The Commerce Clause plays an important role in preventing discrimination against out-of-state businesses because the Privileges and Immunities Clause does not apply to corporations or other businesses; rather, it protects only individual citizens.

obligations.⁵⁸ This formalistic use of the place of contracting rule served to protect party expectations. However, the Court has since retreated from this analysis to permit the application of any law connected with the contract at the time the contract was formed.⁵⁹ Although this approach was more flexible than a place of contracting rule, it at least prevented the application of laws unconnected to the transaction at issue.

The Court's use of the Full Faith and Credit Clause similarly evolved from clear recognition of the parties' ex ante expectations to a looser standard. In a series of cases involving fraternal benefit associations the Court held that members' rights must be determined according to the law of the place of formation of the organization.⁶⁰ While the Court stressed the need for uniform rights for owners of a common fund, it refused to apply the internal affairs doctrine (which would make the law of the state of incorporation or organization govern).⁶¹

⁵⁸ N.Y. Life Ins. v. Dodge, 246 U.S. 357 (1918).

⁵⁹ John Hancock Mut. Life Ins. v. Yates, 299 U.S. 178 (1936); Home Ins. Co. v. Dick, 281 U.S. 397 (1930).

⁶⁰ See, e.g., Order of United Commercial Travelers v. Wolfe, 331 U.S. 586 (1947); Sovereign Camp of Woodmen of the World v. Bolin, 305 U.S. 66 (1938); Modern Woodmen of America v. Mixer, 267 U.S. 544 (1925); Supreme Council of the Royal Arcanum v. Green, 237 U.S. 531 (1915).

⁶¹ Modern Woodmen, supra note 48, at 551.

After *Erie* brought greater federal court deference to state law, the Court turned to something approaching state interest analysis,⁶² rejecting party choice principles. Moreover, in *Allstate Insurance Co v. Hague*,⁶³ the Court signaled that it was unlikely to second-guess state conflicts laws. The Court held that Minnesota could apply its own law to an insurance contract even though the policy was issued and the insured resided in Wisconsin and the accident occurred in Wisconsin. This choice was justified because the decedent worked in Minnesota, his widow became a Minnesota resident after the accident, and the insurer was doing business in Minnesota. The Court reasoned that there was “no element of unfair surprise or frustration of legitimate expectations as a result of Minnesota's choice of its law.”⁶⁴ This very broad acceptance of the use of forum law gives parties little ability to plan their activities based on applicable law.⁶⁵

⁶² See *Watson v. Employers Liab. Ins.*, 348 U.S. 66 (1954) (applying law of customer’s residence state in permitting customer’s direct action against the manufacturer’s insurer); *Clay v. Sun Ins. Office, Ltd.*, 377 U.S. 179 (1964) (applying insured’s residence state in invalidating time limit on suit).

⁶³ *Allstate Ins. Co. v. Hague*, 449 U.S. 302 (1981).

⁶⁴ *Id.* at 318 n.24.

⁶⁵ Following *Hague*, the only case in which the Court struck down a state choice-of-law decision on Constitutional grounds was where a Kansas court applied its law to land leases with no connection at all to Kansas in order to enable the court to hear a class action involving the leases. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985).

Because courts have never used the Equal Protection and Privileges and Immunities Clauses in the context of choice-of-law, the dormant Commerce Clause is the final potential constitutional basis for scrutinizing state choice-of-law decisions. This ground is promising, since it potentially enables courts to strike down decisions even where the parties might have expected a similar result from past decisions. The Court has sometimes invalidated state regulation under the Commerce Clause when the regulation would enable a single state to impose burdens on national businesses everywhere. For example, a state could not require interstate trucks passing through it to have different mudguards than those most states permitted and at least one state required.⁶⁶ The Court has similarly prevented states from requiring national firms to revise their tender offers for their Illinois shareholders.⁶⁷ However, the latter result was based on Congress's enactment of national tender offer legislation. It is unlikely the Court would compel a state to apply another state's law under the dormant commerce clause solely because that state was designated in a choice-of-law clause.

The basic problem in all these cases is that neither the Court nor Congress cares enough about the allocation of authority across the states to give choice-of-law sustained attention. We now turn to the question of the extent to which parties can use choice-of-court and arbitration clauses to enhance their choices of governing law.

Choice-of-court clauses

⁶⁶ See *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959).

⁶⁷ *Edgar v. MITE*, 457 U.S. 624 (1982).

So far we have seen that conflicts of law rules leave state and federal courts quite free to apply local law to cases before them even if the case involves a contract with a clause choosing the law of another state. Yet states differ in the extent to which they are willing to apply the chosen state's law. Not surprisingly, the chosen state is almost always willing to apply local law. As a result, there is a close connection between contractual selection of the *court* and the choice of the law to govern. Typically the key problem for potential defendants is that *plaintiffs* generally choose the court unilaterally by deciding where to sue. Firms can counteract plaintiffs' ability to choose the forum ex post by inserting choice-of-court clauses in their contracts which designate the state or federal court where the parties' disputes will be litigated. These clauses also operate as agreements to submit to the personal jurisdiction of the chosen court. Not surprisingly, a study of merger and acquisition agreements found that contracts choosing a particular law to govern the transaction are likely also to provide for resolution of the disputes in the same state's courts.⁶⁸

It might seem that parties would gain little from choice-of-court clauses that they do not get from choice-of-law clauses. If a party sues in a court other than the one the contract selects, the forum likely will recognize that if it enforces the choice-of-court clause then the chosen court will agree to apply its forum law. Thus, courts that are hostile to choice-of-law clauses would be expected also not to like choice-of-court clauses. Indeed, some scholars have criticized choice-

⁶⁸ See Eisenberg & Miller, *supra* note 40. However, only half of the contracts with choice of forum clauses have choice-of-law clauses.

of-court clauses as a way to manipulate the governing law.⁶⁹ Courts and commentators once generally held that enforcing these clauses would amount to an illegal “ouster” of a court's jurisdiction.⁷⁰

Courts, however, have greater incentives to enforce choice-of-court clauses than they do choice-of-law clauses despite the clauses' apparently similar effects. The former type of contract relieves the court from explicitly weighing the policies in local law against those of another state. It also enables a court with a crowded docket to lighten its case load.

Today states quite routinely do enforce choice-of-court clauses, at least in commercial cases.⁷¹ The Supreme Court spurred this development in decisions applying federal law, particularly those involving the federal courts' exclusive admiralty jurisdiction. *M/S Bremen v. Zapata Off-Shore Co.*⁷² enforced a choice-of-court clause in a commercial admiralty case, concluding that the clause “was a vital part of the agreement” and that the “consequences of the

⁶⁹ See Lee Goldman, My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts, 86 Nw. U. L. Rev. 700 (1992); Linda S. Mullenix, Another Choice of Forum, Another Choice-of-law: Consensual Adjudicatory Procedure in Federal Court, 57 Fordham L. Rev. 291 (1988).

⁷⁰ See Eugene F. Scoles & Peter Hay, Conflict of Laws § 11.3 (2d ed. 1992).

⁷¹ See Leandra Lederman, Viva Zapata!: Toward a Rational System of Forum-Selection Clause Enforcement in Diversity Cases, 66 N.Y.U. L. Rev. 422, 449 n.172 (1991); Michael E. Solimine, The Quiet Revolution in Personal Jurisdiction, 73 Tul. L. Rev. 1, 17 & n.107 (1998).

⁷² *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972).

forum clause [figured] prominently in [the parties'] calculations.”⁷³ The Court extended this reasoning into the consumer context in *Carnival Cruise Lines, Inc. v. Shute*,⁷⁴ in which it enforced a choice-of-court clause buried in the fine print of a consumer passenger cruise line ticket.

Even if state courts refuse to enforce choice-of-court clauses, defendants can remove their cases to federal courts seeking federal diversity jurisdiction and use the court selection clause as a basis for having the case transferred to the selected federal court. The Supreme Court held in *Steward Org., Inc. v. Ricoh Corp.*⁷⁵ that federal law, which would include the U.S. Supreme Court’s policy on forum selection clauses, applies in deciding whether to grant the transfer motion.

Court selection clauses have found greater traction in federal courts because these courts are more responsive to national interests than to local state legislatures. These national interests in international commerce, in turn, are affected by potential competition from foreign countries. Indeed, *The Bremen* Court reasoned:

[I]n an era of expanding world trade and commerce, the absolute aspects of the doctrine of [non-enforcement of choice-of-court clauses] have little place and would be a heavy hand indeed on the future development of international commercial dealings by

⁷³ *Id.* at 13-14.

⁷⁴ *Carnival Cruise Lines, Inc. v. Schute*, 499 U.S. 585, 593-94 (1991).

⁷⁵ *Steward Org. v. Ricoh Corp.*, 487 U.S. 22 (1988).

Americans. We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts.⁷⁶

The national interest looms large in connection with potential ratification of the Hague Convention on Choice of Court Agreements. Article 5(1) of the Convention provides that “[t]he court or courts of a Contracting State designated in an exclusive choice of court agreement shall have jurisdiction to decide a dispute to which the agreement applies, unless the agreement is null and void under the law of that State.”⁷⁷ Ratification of this Convention might spur the U.S. to adopt a federal law requiring states to enforce choice-of-court clauses in order to compete with other countries that ratify the Convention.⁷⁸

Despite the broad enforcement of choice-of-court clauses, the ability of plaintiffs unilaterally to choose where to sue importantly undermines party choice. Consider, for example, a study showing that even in corporate cases, where jurisdictional choice is firmly entrenched through the internal affairs doctrine,⁷⁹ non-Delaware courts are hearing a sharply increasing

⁷⁶ *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972).

⁷⁷ Convention on Choice of Court Agreements, June 30, 2005, Hauge Conference on International Law, available at http://www.hcch.net/index_en.php?act=conventions.pdf&cid=9.

⁷⁸ See William J. Woodward, Jr., Saving the Hague Choice of Court Convention, 29 U. Pa. Int’l L. 657 (2008).

⁷⁹ See Larry E. Ribstein & Erin A. O’Hara, Corporations and the Market for Law, 2008 ILL. L. REV. 661.

number of cases involving Delaware corporations.⁸⁰ The study suggests that ex post forum selection could threaten one of the few seemingly unqualified successes of ex ante jurisdictional choice.

Arbitration

Enforcement of arbitration agreements has significantly influenced enforcement of choice-of-law and choice-of-court clauses. Commercial arbitration has spread globally because of international competition for trade. England began the competition by making arbitration clauses enforceable by statute in 1886 and attracting business to the London Court of Arbitration.⁸¹ The New York Chamber of Commerce lobbied the New York legislature to compete with London by adopting a similar statute.⁸² In the early 1920s, New York and New Jersey adopted the first U.S. arbitration statutes.⁸³ In order to ensure nationwide enforcement of

⁸⁰ See John Armour, Bernard S. Black & Brian R. Cheffins, *Is Delaware Losing its Cases?* (March 25, 2010), Northwestern Law & Econ Research Paper No. 10-03, <http://ssrn.com/abstract=1578404>.

⁸¹ Geoffrey P. Miller & Theodore Eisenberg, *The Market for Contracts*, 30 *Cardozo L. Rev.* 2073, 2081 (2009).

⁸² *Id.* at 23 & n.64.

⁸³ Bruce L. Benson, *An Exploration of the Impact of Modern Arbitration Statutes on the Development of Arbitration in the United States*, 11 *J. L. Econ. & Org.* 479, 481 (1995).

arbitration awards, Congress passed the Federal Arbitration Act (FAA) in 1925, which binds state and federal courts to enforce arbitration provisions in contracts.

The New York Convention on Arbitration, signed by the U.S. in 1958 and today by more than 140 other nations, further helped promote global enforcement of arbitration awards and thereby prevented parties from evading arbitration by moving assets into non-enforcing countries.⁸⁴ The Convention requires its signatories to enforce written agreements to arbitrate disputes⁸⁵ and to refrain from imposing substantially more onerous conditions on the recognition or enforcement of foreign arbitral awards than they impose on the recognition or enforcement of domestic arbitral awards.⁸⁶ Within the US, states have competed to be venues for arbitration proceedings and to have their laws selected in commercial contracts, and lawyers have found they can earn fees as arbitrators and represent parties in arbitration.⁸⁷

The popularity of arbitration in the U.S. has been helped by pro-arbitration U.S. Supreme Court decisions interpreting the Federal Arbitration Act. The Court has held, for example, that the validity of the contract (though not of the arbitration provision) is a matter for the

⁸⁴See http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html.

⁸⁵ Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 UST. 2517, 330 U.N.T.S. 3, Art. II (hereinafter New York Arbitration Convention).

⁸⁶ *Id.* at Art. III.

⁸⁷ Benson, *supra* note 83, at 496 & n.23.

arbitrator,⁸⁸ and that states may not require administrative review of regulated contracts as a prerequisite to arbitration.⁸⁹ The Court also has held arbitrable disputes involving such public laws as the antitrust,⁹⁰ securities,⁹¹ antiracketeering,⁹² civil rights and employment discrimination statutes.⁹³ The Court often stresses in these cases that arbitration helps the U.S. compete in a world economy.

Although arbitration has been a success so far in the U.S. and globally, the same interest groups that oppose enforcement of contractual choice-of-law and court also are threatening arbitration. Arbitration is already unenforceable in franchise contracts between automobile manufacturers and dealers,⁹⁴ and Congress is considering a law that would broadly invalidate arbitration clauses in consumer and employment contracts.⁹⁵ Some courts have held that

⁸⁸ See *Buckeye Check Cashing, Inc. v. Cardegna*, 126 S. Ct. 1204 (2006).

⁸⁹ *Preston v. Ferrer*, 552 U.S. 346 (2008).

⁹⁰ *Mitsubishi v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985)

⁹¹ *Scherk v. Alberto-Culver, Co.*, 417 U.S. 506 (1974).

⁹² *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

⁹³ *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991) (age discrimination claims arbitrable)

⁹⁴ Sec. 11028(a)(2) of Pub. L. 107-273, 116 Stat. 1836 (2002).

⁹⁵ Sec. 1782, Arbitration Fairness Act, Cong. Rev. S. 9144 (July 12, 2007).

arbitration clauses cannot circumvent class-wide dispute mechanisms, applying arguably stricter unconscionability standards to arbitration than to other contract terms⁹⁶ and some companies, more afraid of class-wide arbitration orders than they are of U.S. courts, have responded to this development by removing arbitration clauses from their contracts. Notwithstanding this potential threat, arbitration clauses remain more enforceable in the U.S. than in any other nation, and the widespread enforcement of arbitration clauses somewhat tempers the effects of the American Illness present in U.S. courts.

Conclusion

In sum, the U.S. federal system offers significant potential for jurisdictional choice as a partial solution to misguided or inappropriate law. However, this system is not only an imperfect solution, but can itself be a source of bad law and runaway litigiousness. Firms that do business nationally or internationally have no guarantee of avoiding being hailed into the courts of any of the 50 U.S. states and subject to its oppressive law. Federal law and enforcement of contractual choice-of-law, choice-of-court, and arbitration clauses provide some, but only partial, relief. The

⁹⁶ The Supreme Court is currently considering whether the Federal Arbitration Act preempts such determinations. See *Laster v. AT & T Mobility LLC* 584 F.3d 849 (9th Cir. 2009) (cert. granted, May 24, 2010).

U.S. is losing an opportunity to exploit the edge it might get from its federal system in international competition.⁹⁷

⁹⁷ A full analysis of international competition calls for a comparison with other jurisdictions, and particularly other federal systems. Elsewhere we undertake such a comparison. Erin Ann O'Hara & Larry E. Ribstein, Rules and Institutions In Developing A Law Market: Views From The United States And Europe, 82 Tul. L. Rev. 2147 (2008).