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## CORRESPONDENCE

### Territoriality and the Perils of Formalism

Mark P. Gergen\*

Recently in this journal<sup>1</sup> Donald Regan published a pair of essays on *CTS Corp. v. Dynamics Corp. of America*.<sup>2</sup> Much of the first essay elaborates his theory that what the Supreme Court should be doing and what it is doing<sup>3</sup> under the dormant commerce clause is checking state laws adopted with a substantial protectionist purpose.<sup>4</sup> The rest of the first essay and all of the second essay develop a different check on state lawmaking power in interstate affairs: a rule that states may not regulate conduct beyond their borders. He calls this the extraterritoriality principle. Elsewhere I have questioned whether Regan's theory of protectionism is sufficient to explain what the Court is and should be doing under the dormant commerce clause.<sup>5</sup> Here I want to question the extraterritoriality principle. My argument is that it works poorly, if it works at all, as a check on the regulatory authority of states. I also make the broader point that Regan's two proposals are overly formal. They blind us to what should be our real concerns when reviewing state laws that affect out-of-state interests and may generate an intolerable number of bad results. At the end I briefly sketch an alternative approach to these problems that is more open-ended.

Regan initially states the extraterritoriality principle vaguely: "For the most part, states may not legislate extraterritorially, whatever exactly that means."<sup>6</sup> If this is all there were to the principle it would be uninteresting. But he adds a critical gloss: what states may not do is directly regulate behavior beyond their borders.<sup>7</sup> This

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\* Assistant Professor, University of Texas School of Law. — Ed. Doug Laycock provided invaluable criticism.

1. Regan, *Siamese Essays: (I) CTS Corp. v. Dynamics Corp. of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation*, 85 MICH. L. REV. 1865 (1987).

2. 107 S. Ct. 1637 (1987).

3. See 107 S. Ct. at 1653 (Scalia, J., concurring).

4. This is developed at length in Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091 (1986).

5. Gergen, *The Selfish State and the Market*, 66 TEXAS L. REV. (1988) (forthcoming) [hereinafter *Selfish State*]; Gergen, *Equality and the Conflict of Laws*, 73 IOWA L. REV. (1988) (forthcoming) [hereinafter *Conflict of Laws*].

6. Regan, *supra* note 1, at 1896.

7. *Id.* at 1899.

rule has two components. First, states may indirectly influence foreign behavior by acting upon its local effects. Michigan, for example, may influence Indiana polluters by making them liable for emissions that poison Michigan air. Second, states may not regulate foreign behavior directly. Regan's example of the difference between direct and indirect regulation of foreign behavior is hard to improve on. Michigan may ban cigarette smoking within its borders whatever the effect of the prohibition on southern industry. Michigan may not directly prohibit the manufacture of cigarettes in North Carolina.<sup>8</sup>

The distinction between direct and indirect extraterritorial regulation is what makes Regan's proposal different from other territorialist theories. The problem with most territorialist theories is that once we allow states to regulate foreign behavior because of the local effects of such behavior, a power states clearly enjoy today, nearly all extraterritorial laws pass constitutional scrutiny. After all, states really care about regulating foreign behavior only when it affects them.<sup>9</sup> Regan puts some teeth back into the territorial principle by denying states the power to regulate foreign behavior directly whatever its local effects.<sup>10</sup>

This is the heart of Regan's theory. He refers to the distinction between regulating local and foreign behavior to explain why the Court may have been right in *CTS* and in *Edgar v. MITE Corp.*,<sup>11</sup> respectively upholding and striking down Indiana and Illinois laws regulating tender offers. Both laws imposed restrictions on transfers of corporate stock in tender offers. For Regan the important difference between the two cases is that the Indiana law regulated only tender offers for firms incorporated in the state while the Illinois law also regulated offers for firms doing substantial business in the state but incorporated elsewhere.<sup>12</sup> Having decided that transfers of corporate stock occur in the state of incorporation,<sup>13</sup> Regan concludes that Indiana was regulating internal behavior within its sphere of authority

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8. *Id.* at 1899-900.

9. The only hard cases under an effects principle are those where citizens of states travel abroad, are injured, and then return home and claim the protection of their home state's laws or courts. The power of states to act even in these cases may be squeezed under an effects principle; indeed, it is hard to keep it out because the local implications of foreign injuries are hard to distinguish from other jurisdictional effects. Gergen, *Conflict of Laws*, *supra* note 5.

10. It is somewhat ironic that while making a plea for territorialism, Regan agrees that states may regulate their citizens when they go abroad. Regan, *supra* note 1, at 1906-10. I tend to agree with him that states do and should have such power. See Gergen, *Conflict of Laws*, *supra* note 5. This raises the question whether states may regulate out-of-staters to protect citizens from injury when they travel to other states. Regan does not consider this issue.

11. 457 U.S. 624 (1982).

12. Regan, *supra* note 1, at 1897, 1899.

13. *Id.* at 1878-79.

while Illinois was regulating foreign stock transfers.<sup>14</sup>

But Regan's extraterritoriality principle is ultimately a poor tool for defining the limits of state power in interstate matters. The principle does not seriously restrain the states. Whatever ends a state might wish to accomplish by directly regulating foreign behavior usually can be met by indirect regulation. To take Regan's hypothetical Michigan cigarette ban, by making it a crime, punishable by death, to manufacture a cigarette that finds its way into Michigan, the state may accomplish much the same thing as directly prohibiting cigarette manufacture in North Carolina. Faced with such a risk, cigarette plants across the nation would quickly be closed by their owners. If this seems far-fetched, consider the effectiveness of punitive damage remedies for defectively designed products used in-state as a means of directly regulating the manufacture of products abroad. Or consider the law in *Brown-Forman Distillers Corp. v. New York State Liquor Authority*.<sup>15</sup> It required liquor wholesalers to affirm that they would sell liquor nationally at a price no higher than they sold it in the state in the preceding month. The Supreme Court struck down the law, the correct result in Regan's view because of the extraterritoriality principle.<sup>16</sup> New York was impermissibly reaching out directly to regulate the price at which liquor is sold outside the state. But New York could accomplish much the same end by making the law retrospective, requiring liquor wholesalers to charge no more for sales in-state than they charged nationally in the *preceding* month. This saves the law from the extraterritoriality objection (as Regan observes)<sup>17</sup> because such a law does not directly regulate foreign pricing.<sup>18</sup>

One may even purge the taint of extraterritoriality from Illinois's law seeking to influence shifts in ownership or corporations doing substantial business in the state but incorporated elsewhere. Directly reg-

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14. Other scholars consider these decisions hard to reconcile. See, e.g., Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp. v. Dynamics Corp. of America*, 101 HARV. L. REV. 96, 97 (1987).

15. 476 U.S. 573 (1986).

16. Regan, *supra* note 1, at 1903.

17. *Id.* at 1905.

18. In *Brown-Forman* the Court limited its decision to prospective pricing laws. It had earlier upheld a retrospective law in *Joseph E. Seagram & Sons, Inc. v. Hostetter*, 384 U.S. 35 (1966). Whether *Seagram* remains valid is unclear. The *Brown-Forman* Court said: "[W]e do not necessarily attach constitutional significance to the difference between a prospective statute and the retrospective statute at issue in *Seagram*. Indeed, one could argue that the effects of the statute in *Seagram* do not differ markedly from the effects of the statute at issue in the present case." 476 U.S. at 584 n.6. This broadening of the rule in *Brown-Forman* is fatal to Regan's proposal. If the extraterritorial effects of regulating local behavior give rise to constitutional objections, a host of laws becomes suspect and some sort of balancing will be necessary to tell the good from the bad.

ulating stock transfers is barred if we agree with Regan that they take place in the state of incorporation. But Illinois may regulate the local effects of changes in corporate ownership. If the state fears local plants will close and assets will be taken outside the state, it may prohibit such actions if they closely follow a takeover that violates stipulated standards. The regulation's direct effect is internal; it only indirectly discourages tender offers (and so stock transfers) outside the state.<sup>19</sup>

In the case of laws not drafted to avoid the principle it may be difficult to tell whether what is being regulated is extraterritorial behavior or its local effects. Consider a libel law: does it penalize the libelous utterance made outside the state or its publication in the state? What if a speaker's good faith is made an absolute defense? Does that make the law more a regulation of foreign behavior since now it speaks directly to foreign behavior? Or consider a law that imposes civil liability for polluting state water. Is it regulating the act of polluting or the in-state effect? One would probably say the latter, but what if the law makes it a defense that the polluter used the best available technology? Now it seems to be directly regulating out-of-state behavior.

Some laws regulate intangible things which occur in no particular place. Applying the principle then depends upon the fictional location of the thing regulated. Regan considers one such problem at length: locating transfers of corporate stock.<sup>20</sup> Another example is state laws regulating interstate consumer credit.<sup>21</sup> Whether such laws seek to regulate in-state or out-of-state behavior depends upon the fictional location of contract formation, an issue that never was satisfactorily resolved in choice of law.

If jurists apply the territorial principle mechanically, focusing on whether laws regulate local effects or foreign causes by examining their objective form, these problems will be resolved in ways that often seem arbitrary and incorrect. Consider an out-of-state lender who specifies that its advertisements are solicitations of offers and that loan

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19. It is not clear that Regan would strike down all such laws as protectionist under the commerce clause. He suggests that laws may not be protectionist if states adopt them because they think it would be better for all states if industry was less mobile. Regan, *supra* note 1, at 1871-72. How to deal with selfish policies pursued by states for nonselfish reasons is a perplexing problem for a motive-based theory. I suggest elsewhere that this same issue is posed by the interest-based approach to choice of law. There I conclude that while it is not so bad if states act selfishly for honorable reasons, the point is of little practical consequence because it is hard to distinguish in practice between evil and benign acts of selfishness. Gergen, *Conflict of Laws*, *supra* note 5.

20. Regan, *supra* note 1, at 1876-79.

21. The Uniform Consumer Credit Code extends restrictions on charges to loans made by residents outside states. UCCC § 1.201(7)(a) (1974).

applications will be accepted, and loans made, at its home-office. A judge who mechanically applies the principle that states may not directly regulate foreign behavior could strike down a law regulating such an out-of-state loan. This would be required by the principle of extraterritoriality, taken literally, but it is bad constitutional law.

Regan recognizes that it is often difficult to tell whether a law regulates local or foreign behavior. Speaking of the specific problem of locating transfers of corporate stock (or other intangible things) Regan argues, "This is the sort of difficulty formalism leads to. In the end, some hard cases must simply be decided by judicial intuitions concerning the spirit of the Constitution."<sup>22</sup> He concludes that stock transfers occur in the state of incorporation for the sensible, policy-based reason that some state (but only one state) should be able to regulate corporate transfers. The state of incorporation is as likely a candidate as any.<sup>23</sup> Be clear what Regan is doing. He resolves the familiar problem of indeterminacy by telling the Court to consider what is good policy at the levels of formulating principle and of classifying laws (or the behavior they regulate) as internal or extraterritorial. The principle of extraterritoriality is little more than a facade, at least in hard cases, behind which the Court will decide cases on the basis of "intuitions concerning the spirit of the Constitution."

This is worse than balancing (Regan's *bête noire*) for several reasons. Regan would require courts to express decisions in terms that have nothing to do with our real concerns. Laws regulating tender offers, for example, would seem to rise or fall not on the weight of the state interest served and the burden to the nation, but rather on the fictional placement of stock transfers. Decisions will be less candid if they do not explain the real reasons why the principle was applied in a particular fashion. This makes decisions less persuasive. It mystifies those who do not know that the application of the principle of territoriality in specific cases depends upon "judicial intuitions concerning the spirit of the Constitution." Perhaps worst of all, some jurists may take the principle literally and strike down good laws because they seem to regulate foreign behavior directly. If there were few hard cases, or if the distinction between direct and indirect extraterritorial regulation was relevant to any real concern, these problems with Regan's proposal would be tolerable. But, as we have seen, many cases will be hard because there is no clear distinction between regulating foreign behavior and regulating its local effects.

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22. Regan, *supra* note 1, at 1879.

23. *Id.* at 1878-79.

Regan's version of territoriality has little to do with our real concerns. Territorialism rests on the belief that the essential division of authority between states is territorial, and, in some more extreme versions, that this division of authority carries with it the ideal that every event is subject to only one authority.<sup>24</sup> The ideal of singular sovereignty is unattainable, of course, for it is inevitable in a world where behavior touches several states that each sovereign will claim the authority to act upon it. But even if we wanted a territorialist system with singular sovereignty, Regan's direct/indirect distinction is not a reasonable way to allocate power. If an Indiana polluter poisons Michigan air, whether Michigan properly regulates his behavior has nothing to do with how directly it acts upon the out-of-stater. What matters is the weight of Michigan's interest in the out-of-state behavior. Indeed, making directness relevant has the perverse effect, noted earlier, that Michigan could impose strict liability for polluting its air but it could not make the foreign polluter's use of the best available technology a defense.

This brings us to a broader criticism of Regan's approach to the problem of limiting the power of states in interstate matters. This goes not only to his principle of territoriality (which Regan proposes tentatively), but also to his more important proposal that in enforcing the dormant commerce clause the Supreme Court should be concerned only with checking laws adopted with a substantial protectionist purpose (to enrich local commercial interests at the expense of foreign interests). I have explained in some detail the problems with this proposal elsewhere and will only summarize the argument here. While a concern with protectionism is a vital part of the law, it is not sufficient to explain what the Court is doing or should be doing. Many state laws adopted with the likely purpose of enriching locals at the expense of out-of-staters (examples include subsidies to local industry, quarantines or embargoes of infected goods, and reciprocal laws) are tolerated.<sup>25</sup> At the same time, some laws will be struck down despite their nonprotectionist motives (examples include a tariff adopted to raise revenues and an embargo adopted to protect the environment).<sup>26</sup>

Looking at this pattern, and asking what is our real concern when states make laws that affect out-of-state interests, it seems to me that

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24. This is Doug Laycock's territorialist manifesto. Regan comes close to saying this when he reasons that territorialism is implicit in the geographic division of sovereignty, Regan, *supra* note 1, at 1887-95, and, more importantly, when he insists an important function of the territoriality principle is to ensure that events are regulated by one, but only one, sovereign. *Id.* at 1882.

25. Gergen, *Conflict of Laws*, *supra* note 5; Gergen, *Selfish State*, *supra* note 5.

26. Gergen, *Conflict of Laws*, *supra* note 5.

what we want to check is state laws of disutility, or laws that enrich states but at greater expense to out-of-staters or the nation. A concern with protectionism is consistent with this, for, as Regan observes, laws adopted with a purpose of enriching citizens at the expense of out-of-staters are likely to be inefficient.<sup>27</sup> This also explains why subsidies, quarantines, and reciprocal laws may be tolerated, for either they are likely to be of positive utility (quarantines enhance the general welfare by preventing the spread of disease), or it is impossible to craft a rule prohibiting them that would not imperil laws of positive utility (subsidies such as hire-local laws should be tolerated because they cannot be distinguished from public employment programs). And it explains why we must sometimes prohibit laws though their motive is not evidently protectionist. States may injure out-of-staters, and harm the nation as a whole, by adopting laws with disregard for out-of-state interests, as well as by consciously trying to take advantage of such interests.

Regan is not blind to these problems. Sometimes he manipulates the principles to avoid bad results. For example, in the case of grossly uneven but well-motivated laws (tariffs adopted to raise revenues or embargoes adopted to protect the environment) Regan is willing to assume their motive is bad without regard to the actual evidence.<sup>28</sup> And he saves subsidies from the rule by fiat: only laws "analogous in form to the traditional instruments of protectionism" are prohibited.<sup>29</sup> (This is akin to his proposal that the location of geographically indeterminate acts, like stock transfers, be defined with an eye to what is the most sensible rule.) But other times the rigidity of the principles forces unattractive, and probably unnecessary, outcomes. For example, by prohibiting only traditional forms of protectionism Regan would allow certain subsidies, such as preferences for citizens in the sale of goods by state-owned plants, that could and should be stopped under a more flexible standard.<sup>30</sup>

This may not be bad. We may be so concerned that the Court will take advantage of a license to balance that we want to force it to work within fairly rigid principles that constrain its discretion. If there is a justification for Regan's principle of protectionism, it is this.

But there may be a better approach. Establish the principle that it is not the province of the Court to weigh closely the costs and benefits

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27. Regan, *supra* note 4, at 1115-20.

28. *Id.* at 1119-23. I explore this inconsistency at length in Gergen, *Conflict of Laws, supra* note 5.

29. Regan, *supra* note 4, at 1095.

30. Gergen, *Selfish State, supra* note 5.

of laws. When state laws are challenged, the primary issue is whether their motive was substantially protectionist. But do not close the system there. Though the motive of a law seems bad, let it be upheld if the state can make a strong showing that its benefits outweigh its costs. In undertaking this analysis pay close attention to precedent. If a law is the sort of protectionist law that has been tolerated in the past (e.g., a subsidy, quarantine, or reciprocal law), the Court should incline to uphold it. This makes incremental change in either direction possible. If a law is on the margin of something traditionally allowed — for example, a preference for citizens in sales of goods from state-owned plants — but it seems inefficient, precedent should not save it. Ultimately, the traditional rule, if it is a bad one, will be eaten away. Conversely, though a law seems a product of no ill will, the Court should not be reluctant to strike it down if it seems the costs greatly outweigh the benefits. Again, attention should be paid to whether it is the sort of law, such as an embargo, which is usually forbidden.

This is not that different from Regan's theory of protectionism. (His principle of territoriality I would discard entirely.) It just takes the concern of utility (or efficiency) that informs much of his analysis and brings it closer to the front. The major difference is that rather than saying the Court should never balance, I say that it may sometimes do so. But it must be careful not to second-guess plausible policy judgments and be mindful of the need not to vary too far, too fast, from precedent. The advantages are twofold. Perhaps, there will be less error. Definitely, cases will be argued and decisions reasoned on the basis of the factors actually relevant to how we want them decided.