

## Supreme Court Clarifies Corporate Citizenship Test for Diversity Jurisdiction



By Ty E. Shaffer

The U.S. Supreme Court's opinion in *Hertz Corp. v. Friend*, which was decided in February of this year, never was as likely to make headlines as some of the Court's other recent decisions. But while the Court's pronouncements on the Second Amendment right to bear arms or the applicability of campaign finance laws to corporations and unions might be sexier topics for pundits, the *Hertz* decision is probably more significant for our corporate clients. In a unanimous decision, the Supreme Court clarified the test for corporate citizenship to be applied when determining federal courts' diversity jurisdiction—a corporation is a citizen of the state where its “nerve center” is located. The case will have a major impact on determining when corporations can sue and be sued in federal court and should be taken into consideration, along with other factors, in determining where to incorporate and to headquarter a corporation.

Our federal structure of government is rightly touted as one of the Founders' most brilliant contributions to posterity. But the division of powers between state and federal governments presents interesting legal problems. For example, both the states and the federal government pass laws that govern the actions of individuals and business entities. How do we know when to apply state law, and when to apply federal law? Likewise, both the states and the federal government have courts that administer justice. What types of claims properly are heard in state courts, and when should a claim be heard by a federal court?

On the question of federal versus state court jurisdiction, Article III of the Constitution gives us some guidance. The Constitution authorizes Congress to give the federal courts jurisdiction in several types of cases, the two most important of which are “federal question” cases and “diversity” cases. Congress long ago enacted statutes to create these two categories of federal court jurisdiction.

“Federal question jurisdiction” covers all suits that arise under the Constitution, laws, or treaties of the United States. In other words, claims that are based on federal law are to be heard in federal courts. In addition, federal courts exercise “diversity jurisdiction” over cases (i) where the amount in controversy (generally, the damages the plaintiff claims) exceeds \$75,000, and (ii) the parties are citizens of different

states—in legal jargon, where there is “diversity of citizenship.” For example, if a citizen of North Carolina sues a citizen of South Carolina for \$100,000 for a breach of contract, this suit could be heard in federal court, even though the law governing that contract is state law. The diversity of citizenship must be complete, meaning that in a case with multiple plaintiffs or multiple defendants, none of the plaintiffs can be a citizen of the same state as any of the defendants.

If a lawsuit has been filed in state court, but one of these bases for federal jurisdiction applies—that is, the plaintiff could have filed it in federal court—the defendant can “remove” the suit to federal court. This is a powerful tool, particularly for corporate defendants. Rightly or wrongly, many corporate defendants consider federal judges (life appointees who must be confirmed by Congress) to be “better” judges than their state court colleagues (many of whom are elected officials), and believe they will get a fairer shake in federal court. For example, in states regarded as “tort hells”—states where tort cases in state courts are much more likely to result in large verdicts for plaintiffs—defendants may try to limit their losses by removing a case to federal court on diversity grounds, so that it can be heard before a federal judge.

When a lawsuit is between two individuals, it is easy to determine citizenship—it’s the state of permanent residence. But what about corporations? The federal diversity jurisdiction statute provides that a corporation is a citizen of both (1) the state where it is incorporated, and (2) “the State where it has its *principal place of business*.”

Lower federal courts have been split over exactly what the phrase “principal place of business” means. And this split, which has been a source of much confusion, is why the Supreme Court agreed to hear the *Hertz* case. Some courts focused on locating the corporation’s “nerve center,” while others gave more weight to where the corporation conducted its actual business activities. Still other courts combined aspects of these two tests.

In *Hertz*, two California citizens sued Hertz Corporation in California state court for violation of California wage and hour laws. Hertz sought to remove the case to federal court on diversity grounds, so it had to prove that neither its state of incorporation nor its principal place of business was in California. Because Hertz is a Delaware corporation, the decision hinged on Hertz’s claim that its principal place of business was in New Jersey, not California. In support of the removal, Hertz stated that its leadership was headquartered in Park Ridge, New Jersey, and that its “core executive and administrative functions” were carried out there.

In a fine example of the confusing status of case law interpreting “principal place of business,” the California federal District Court considering Hertz’s attempt to remove the case applied Ninth Circuit (the federal appeals court that covers California) case law, which requires the court first to identify the amount of a corporation’s business activities on a state-by-state basis. If activity is “significantly larger” or “significantly predominates” in one state, then that state is to be considered the principal place of business. However, if there is no such dominant state, the corporation is a citizen of the state where its “nerve center” is located—i.e., the place where “the majority of its executive and administrative functions are performed.” The District Court found that a plurality of Hertz’s business activities took place in California, and that the difference between California-based activities and those in the next closest state was significant. Accordingly, it refused jurisdiction and sent the case back to the California state court. This decision was upheld on appeal by the Ninth Circuit.

In an attempt to resolve this confusion, and to promote a uniform interpretation of federal law, the Supreme Court held in *Hertz* that the phrase “principal place of business” means the corporation’s “nerve center,” or “the place where the corporation’s high level officers direct, control, and coordinate the corporation’s activities,” thereby taking the state-by-state analysis of a corporation’s business activities out of the equation. The Court added that a corporation’s “nerve center” typically will be the corporation’s headquarters.

The Supreme Court outlined three arguments supporting its decision to adopt the nerve center test. First, the Court noted that the plain language of the statute—“principal place of business”—supports the conclusion that courts are to identify a single place within a state. Second, the Court noted that predictability and ease of administration supported the standardization of courts’ application of the diversity statute. Finally, the Court noted that the history of the diversity jurisdiction statute demonstrated that Congress intended to create a test that was easy to apply.

For corporate entities, the *Hertz* decision should provide some predictability regarding the potential to remove cases to federal court. However, corporations still remain open to suits in state courts in their state of incorporation and where their nerve center is located. For example, if a North Carolina citizen brings a suit against a Delaware corporation, but that corporation’s nerve center is located in Charlotte, that corporation will not be able to avoid state court. Thus the *Hertz* decision may provide even greater incentive both to incorporate and to locate executive and administrative operations in states perceived to be friendly to corporate interests.