

# Supreme Court Provides Guidance for Businesses Wishing to Avoid Unfriendly State Courts

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Businesses often wish to avoid litigation in unfriendly state court forums. For that reason it is important to know when removal is possible so that cases can be transferred automatically from state court to federal court, where judges are appointed for life rather than periodically elected by local citizens. Until recently, there was no way to be certain about whether removal would be possible because the federal circuit courts did not all agree about how the law regarding corporate citizenship for purposes of removal jurisdiction should be applied.

On February 23, 2010, the U.S. Supreme Court clarified when businesses can remove a lawsuit from state court and have it heard in the friendlier forum of federal court.<sup>1</sup> The ruling dealt with what is called "diversity jurisdiction" and is seen as highly favorable for businesses, particularly for large companies conducting business in multiple states because it will make it easier for them to know when they will likely be able to avoid the jurisdiction of plaintiff-friendly state courts. The Court noted in its opinion that simple jurisdictional rules and greater predictability are valuable to businesses, and its ruling was necessary to resolve lower court conflicts so that businesses could make sound business and investment decisions.

## *Why Diversity Jurisdiction is Important to Businesses*

A company can be sued in any state where it does business. If a lawsuit does not involve a question of federal law, a company will likely be required to defend the case in state court under the rules and procedures of that state. In that event, a company might have to deal with potentially unfriendly or biased judges, juries, lawyers, rules and procedures in a state where the company is not a local "citizen." But if a company is sued in local court in a state where it is not deemed to be a "citizen," and if the stakes are high enough to be significant by legal standards, federal law allows the company to use "diversity jurisdiction" to move the case from the local or state court into federal court.

Under federal law before 1958, a company was a citizen only in the state where it was incorporated. Because it was believed that some companies were incorporating

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in other states to purposefully avoid being subject to the jurisdiction of local courts where they did business, Congress changed the law in 1958 to provide that companies are citizens in the state of incorporation *and* in the state where the company has its "principal place of business." But Congress did not define what it meant by "principal place of business," so the federal courts were left to decide what that phrase meant.

The federal appellate courts have disagreed about the proper method for determining a company's principal place (or state) of business. The approaches vary from a "total activity" test based on a company's purposes, business and site of operations; a "nerve center" test based on where the company's control and direction is exercised; a "substantial predominance" test based on an examination of what state among those in which the company operates is the predominant one; a "center of corporate activity" test; and tests combining various aspects of each of these tests.

In this era of increased litigation and large class-action cases against businesses, companies most often prefer to defend lawsuits in federal court rather than having to deal with state courts viewed as being more plaintiff-friendly. Therefore, the decision about where a large corporation is a citizen is very important because in all states except that one state (and the state of incorporation if different) a company can use diversity jurisdiction to move a case to federal court, provided that the other requirements for removal are met.

Because federal appellate courts have been inconsistent in their approach and results were unpredictable, Supreme Court resolution of this issue was very much needed. The Supreme Court clarified that a company's principal place of business is where its high level officers actually direct, control and coordinate the company's activities, typically at the company headquarters.

### *The Underlying Dispute*

The dispute in this case arose from the fact that Hertz does a large amount of business in California. Incorporated in Delaware, Hertz has its corporate headquarters in New Jersey; but its biggest volume of business by far is in California when compared to any other single state. The Plaintiffs wanted to litigate against Hertz in California state court where they filed suit. When faced with removal they asked the federal court to ignore Hertz's headquarters location and state of incorporation and find Hertz to be a California citizen based on its volume of business there.

The court case began in September, 2007, when a group of managers sued Hertz in Alameda County, California, claiming that they were not properly paid under California law. The class-action complaint alleged that under California law hundreds of employees were not paid proper overtime, were denied required meal and rest periods, and were denied pay for earned vacation.

Hertz attempted to remove the case to federal district court in California based on diversity jurisdiction. Under the Class Action Fairness Act of 2005, a federal court has diversity jurisdiction over a class-action lawsuit involving 100 or more individuals and

an amount in controversy exceeding \$5 million if any plaintiff is a citizen of a state different from any defendant. The employees were all citizens of California. Hertz asserted that it was not a citizen of California based on its state of corporation (Delaware) and headquarters location (New Jersey).

The employees asked the district court to send the case back down to the state court claiming that Hertz was a California citizen because "Hertz derives more revenue, employs more workers, and rents more cars in California than in any other state," and thus has its "principal place of business" in, and is a citizen of, California. Following the precedent in that circuit, the federal district court ruled that because Hertz's business activity in California is "significantly larger than any other state in which the corporation conducts business," California is Hertz's principal place of business and it is therefore a citizen of California. The court therefore sent the case back to California state court.

Hertz appealed to the U.S. Court of Appeals for the 9th Circuit seeking to keep the case in federal court. The 9th Circuit ruled against Hertz, agreeing with the federal district court that under the "place of operations" test as applied in the 9th Circuit Hertz is a California citizen.

Hertz then appealed to the U.S. Supreme Court, pointing out that it conducts more than 80% of its business outside the state of California, and that under the 9th Circuit's "place of operations" test any company conducting business in California would be a California citizen if its nationwide business is proportionally distributed according to population. Hertz argued instead for nationwide adoption of the "nerve center" test which finds a company's principal place of business to be where its key decisions are made (usually the state where it has its headquarters).

The employees argued that such a test would allow a company to manipulate the system by deciding to locate its headquarters in a particular state just to make certain that cases in other states where it might have its most substantial business would always be removable to federal court. They pointed out that the real purpose behind the test is to prevent local bias against a "foreign" company, and that purpose is not necessarily served by a citizenship test based solely on the location of company headquarters or executives. For example, a company could set up a small "headquarters" location but still have a majority of executives and decision-makers elsewhere; then, for purposes of diversity jurisdiction, it could claim state citizenship where its headquarters is located but where in reality it has only a minimal presence in terms of actual business operations.

In response, Hertz pointed out that the easily-applied "nerve center" test basing corporate citizenship on the location of a company's headquarters should still be adopted as the rule, but could be subject to challenge and further evaluation if it is shown that a company has gamed the system just to avoid state-court jurisdiction where it does substantially all of its business.

The Court did just that, unanimously holding that a company's principal place of business is in the state where its officers "direct, control, and coordinate the corporation's activities." Usually this will be the place where the company has its

headquarters, provided that the company actually has its "nerve center" there – the place where actual direction, control and coordination of activities occurs.

But if the facts show that a corporation is manipulating jurisdiction by simply having a mail drop, board meeting, or other such "bare office" operations in an attempt to establish a state as its principal place of business under this test, then a court can look to where the actual direction, control and coordination occurs to find the true principal place of business for jurisdictional purposes. In the *Hertz* case, the Court vacated the Ninth Circuit's judgment and ordered further proceedings to allow the employees to challenge whether Hertz truly has its headquarters and "nerve center" in New Jersey.

#### *What This Means For Businesses*

Businesses with operations in more than one state can now be more certain about where they can remove cases to federal court. Essentially, if a company ensures that all key decisions are made and control of the business emanates from a clearly established headquarters location, then that is where the company's state citizenship based on its principal place of business is established for purposes of diversity jurisdiction (in addition to its state of incorporation). Then the company can be assured that in other states, lawsuits can be removed to federal court if other conditions are met. Additionally, a company can now select the state where it is willing to stay in state court based on its principal place of business by considering these factors, and by careful planning in advance of any decision to relocate the company's headquarters.

Businesses should be cautious, however, because the Court noted that there would still be hard cases to decide under its nerve center test. The nerve center test is relatively easier to apply, and courts do not have to weigh business revenues, assets or functions to make a determination. But as noted above, companies cannot play games or manipulate circumstances just to establish a state as its principal place of business. So while the *Hertz* case established a new test to be uniformly applied by lower courts for purposes of removal jurisdiction, the case still had to be sent back down so that the parties in California could have a fair opportunity to decide under this test whether Hertz's corporate headquarters in New Jersey is indeed its "nerve center."

Businesses seeking to take advantage of the Supreme Court's guidance should make certain that the corporate headquarters is truly a nerve center where actual direction and control by high level executives occurs. When executives use technology such as the internet to work and make decisions from home or other business locations, this may cause problems if it is shown that the high level executives do not truly "direct, control and coordinate" corporate activities from one location where decisions "radiate" to other corporate locations. It is clear from the Court's opinion that merely having a place where the corporation holds its board meetings is not enough to establish a corporate headquarters. The lower courts will therefore continue to examine facts and circumstances in applying the nerve center test; but if a business is careful to set up its headquarters as the place where actual executive decisions are made and communicated to other corporate locations, the business should be able to successfully establish that location as its corporate headquarters and principal place

of business. Then, in all states other than that state and the state of incorporation, removal from state to federal court on the basis of diversity jurisdiction will be possible in appropriate cases.

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<sup>1</sup> *Hertz Corp. v. Friend*, 130 S. Ct. 1181 (Feb. 23, 2010).