Beyond Competition for Incorporations

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Abstract

This Article documents and analyzes a powerful form of regulatory competition—competition for investments—that has transformed national corporate laws in the European Union in recent years. Unlike competition for incorporations, competition for investments shapes corporate law when firms cannot easily incorporate outside the jurisdiction in which they operate. These dynamics are not unique to the European Union. They characterized early nineteenth-century state lawmaking in the United States, and may well characterize lawmaking today outside the European Union. High political payoffs await successful participants in the competition for investments, which enables them to overcome opposition that can stifle competition for incorporations. These payoffs, together with the fact that no single jurisdiction can monopolize the market for investments, can drive multiple jurisdictions—including large ones—to compete. Allowing firms to incorporate abroad, as recent European Court of Justice rulings require, may or may not breed competition for incorporations. But so long as the existing competition for investments does not lose steam, the effect on firms will be the same. Judging from the reforms this competition has produced thus far, the effect will continue to be positive.

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INTRODUCTION

The notion that jurisdictions may compete for incorporations by tailoring their corporate laws to the preferences of corporate decisionmakers has long fascinated legal commentators. It is easy to see why. The competition paradigm provides a powerful analytical tool for evaluating the entire body of corporate law without pondering the merits of every detail. All one must do is examine the preferences of those who make incorporation decisions. As long as corporate decisionmakers prefer laws that maximize the value of the firm, jurisdictions will offer such laws.

Nearly half a century of legal scholarship has produced scores of articles explaining state corporate laws in the United States as products of just such competition. The basic facts are undisputed. First, firms in the United States are free to incorporate in any one of fifty states and in the District of Columbia regardless of where they conduct their business. Second, states introduce and copy legal innovations from each other. Finally, the state that innovates and copies more than any other—Delaware—prospers by attracting the most incorporations. These facts leave no doubt that Delaware competes for incorporations. Commentators only disagree over whether other states also compete,[1] and whether corporate decisionmakers pull the competition in a desirable direction.[2]

It could be tempting to apply the same analysis to other parts of the world, with the European Union as a natural place to start.[3] Historically, however, the European Union has not met a necessary condition for a market of incorporations to evolve. Unlike American states, most member states in the European Union have long-followed the so-called real-seat rule, which prevents companies operating in these member states from incorporating abroad.[4] If this rule changed, commentators argued, intense competition for incorporations would follow.[5]

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1. *Compare* Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 580 (2002) (arguing that no American state but Delaware is actively pursuing incorporations), *and* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002) (same), *with* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 607 (2003) (arguing that Delaware's real competition is the federal government), *and* Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 21 OXFORD REV. ECON. POL'Y. 212, 217–23 (2005) (arguing that all American states pursue incorporations).

2. *Compare* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 921 (1982) (arguing that competition produces efficient law), Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 279–81 (1985) (same), *and* Ralph K. Winter, Jr., *State Law Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290 (1977) (same), *with* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1509 (1992) (arguing that competition produces undesirable results for shareholders), *and* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 705 (1974) (arguing that competition results in deteriorating standards).

3. The theory of competition for incorporations has also been applied to Canadian provinces. *See generally* Douglas J. Cumming & Jeffrey G. MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141 (2000); Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 188 (1990).

4. *See* Eddy Wymeersch, *The Transfer of the Company's Seat in European Company Law*, 40 COMMON MKT. L. REV. 661, 666–73 (2003) (reviewing legal barriers to incorporation abroad).

5. *See* BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE, AND OPERATION 443 (1997) (arguing that the English judiciary has attributes that would help the United Kingdom succeed if it chose to compete for incorporations); Simon Deakin, *Regulatory Competition versus Harmonization in European Company Law*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES 190, 204–05 (Daniel C. Esty & Damien Geradin eds., 2001) (arguing that lawyers and accountants may drive member states to compete for incorporations); Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT'L L. 477, 507 (2004) (arguing that member states are likely to compete for incorporations once firms are free to incorporate abroad); Luca Enriques, *EC Company Law and the Fears of a European Delaware*, 15 EUR. BUS. L. REV. 1259, 1273 (2004) (arguing that a

This moment of truth has arrived. In fact, it arrived several years ago, when the first in a series of decisions by the European Court of Justice required member states to recognize companies incorporated in other member states and to refrain from imposing local corporate law on them.[6] Will the freedom to incorporate abroad unleash a wild race among member states to win incorporations? Probably not. There is no reason to believe that European countries will be any more interested in incorporations than most American states, which make little effort to compete with Delaware.[7]

This does not mean that corporate law in the European Union will stand still. It certainly has not done so in the last fifteen years, which saw a surge in corporate legislation in the largest and most industrialized member states. These reforms had nothing to do with competition for incorporations. Instead, they were prompted by mounting pressure on member states to instill trust in their securities markets, which were becoming important drivers of economic growth during a time of mass privatization, capital mobility, and corporate scandals. The reforms took place without any member state relaxing the restrictions on incorporating abroad and applied only to companies operating locally.

This renaissance of corporate legislation within the European Union is not merely unrelated to any market for incorporations. It actually *draws* on the fact

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freedom to choose where to incorporate may pressure national legislators in the European Union to emulate other jurisdictions' rules in order to retain existing corporations, though not in order to attract incorporations from abroad); Gerard Hertig & Joseph A. McCahery, *Company and Takeover Law Reforms in Europe: Misguided Harmonization Efforts or Regulatory Competition?*, 4 EUR. BUS. ORG. L. REV. 179, 187 (2003) (arguing that small member states may compete for incorporations to obtain chartering revenue); Eddy Wymeersch, *Company Law in the Twenty-First Century*, 1 INT'L & COMP. CORP. L.J. 331, 339 (1999) (arguing that a freedom to choose where to incorporate is certain to stimulate competition between member states). *But see* Matthias Baudisch, *From Status to Contract? An American Perspective on Recent Developments in European Company Law*, *in* THE EUROPEAN UNION AND GOVERNANCE 23, 54 (Francis Snyder ed., 2003) (arguing that sufficient incentives to compete for incorporations exist in the United States but not in the European Union).

6. *See* Case C-212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459 (requiring the Danish authorities to recognize a British company operating in Denmark); *see also* Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155, ¶¶ 137–38, 143 (requiring the Dutch authorities to recognize a British company operating in the Netherlands); Case C-208/00, Überseering BV v. Nordic Const. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919, ¶¶ 94–96 (requiring the German authorities to recognize a Dutch company operating in Germany). While these three decisions are most commonly cited in describing the trend, earlier decisions with similar holdings exist. *See, e.g.*, Case 79/85, D.H.M. Segers v. Bestuur van de Bedrijfsvereniging voor Bank en Verzekeringswezen, Groothandel en Vrije Beroepen, 1986 E.C.R. 2375, ¶ 19 (requiring the Dutch authorities to recognize the right of access to a Dutch national sickness insurance scheme for the director of a British company operating in the Netherlands).

7. *See supra* note 1 and accompanying text. Some scholars note initiatives in Germany, the Netherlands, and France to lower incorporation costs in response to an influx of incorporations in the United Kingdom by small, privately-held firms based in these member states. *See* Marco Becht, Colin Mayer & Hannes F. Wagner, *Corporate Mobility and the Costs of Regulation* (Eur. Corp. Gov. Inst.-Working Paper Series in Law, Working Paper No. 70/2006, May 2006), *available at* http://ssrn.com/abstract=906066 (concluding that member states compete to retain domestic incorporations even without tangible benefits). In contrast, this Article focuses on reforms in the core areas of corporate law, which tend to encounter more political resistance and matter to larger, publicly-held firms.

that no such market exists. If companies could easily incorporate abroad, companies operating in member states with inferior corporate laws would be less disadvantaged in their quest for investments, and their home member states would see less urgency in reforming their corporate laws. But without the ability to incorporate abroad, these companies are hamstrung by the corporate laws where they are based. Ironically, precisely because firms *cannot* incorporate elsewhere, member state legislatures need to ensure that local corporate law meets the expectations of the international investor community. This is certainly competition, and an intense one at that, but it owes its existence to the absence of a market for incorporations. Indeed, the same type of competition existed in the United States in the nineteenth century, when American firms lacked the mobility they currently enjoy, and it likely exists today outside the European Union as well.

Competition for investments is different from competition for incorporations, not only in its origin but also in its potency. The incentives for lawmakers to stimulate economic growth are much stronger than the incentives to attract incorporations. Competition for investments can therefore overcome political and economic obstacles that competition for incorporation cannot. In the European Union, competition for investments has overcome opposition from labor and management lobbies, and has resulted not only in copying foreign law but also in forming regulatory agencies with real power and considerable costs of operation. In terms of political and financial commitment, this is more than any American state has done in a century.

The policy implications of this analysis depart significantly from conventional wisdom about the likely outcome of allowing companies to choose where to incorporate. Allowing firms to incorporate abroad may not only fail to foster new competition but may even weaken the competition that already exists. To be sure, the outcome will be different if enough local companies remain incorporated in their home member states. The lack of regulatory interest in companies that incorporate abroad would then be offset by the drive to continue developing law that benefits local companies. This drive may persist especially if the reforms of the last fifteen years have sufficiently transformed national economies and politics to create a self-sustaining momentum. But this will not be competition for incorporations; it will still be competition for investments.

This analysis contributes to the growing scholarship on convergence of corporate governance and path dependence. One strand in the literature, associated with Lucian Bebchuk and Mark Roe, focuses on the limits of the power of globalization to pull corporate laws around the world toward greater efficiency.[8] The other strand, associated with Henry Hansmann and Reinier Kraakman,

8. *See* Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 170 (1999) (noting that important differences persist); *see also* William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm*, 38 COLUM. J. TRANSNAT'L L. 213, 213–14 (1999).

holds that these limits will yield over time to the forces pushing for change.[9] This Article complements the discussion by documenting the forces of convergence at play and relating them to the debate on regulatory competition.[10] In particular, it recasts legal convergence as a form of regulatory competition that is not only more powerful than competition for incorporations but indeed dependent on the very absence of a necessary condition for competition for incorporations.[11]

I. COMPETITION FOR INVESTMENTS

Until recently, firms in most member states of the European Union were unable to incorporate abroad. Competition for incorporations was therefore impossible. But immobility did not prevent the emergence of another type of competition. Far from being hidden, this competition motivates member states to do everything they would do if they competed for incorporations. They liberalize their laws. They tighten shareholder protection. They imitate each other. Only they do all of this to compete for investments—not for incorporations.

The pursuit of investments involves the creation of a hospitable business environment through a combination of financial incentives and physical and legal infrastructure. For years, taxation was the main dimension on which member states competed. But globalization and European integration rendered tax competition insufficient.[12] In addition, the need to shore up budget deficits pushed some member states toward mass privatization, increasing the extent of public stock ownership and the dependence on equity markets. All these changes—together with an economic stagnation, the collapse of major domestic corporations, and a growing awareness of the link between law and finance—led lawmakers to turn their attention to corporate reform as an addi-

9. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (arguing that corporate laws converge); *see also* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 331–32 (2001).

10. Previous commentators have anecdotally mentioned changes in corporate laws in the European Union driven by competition for investments as part of their analysis of competition for incorporations. *See* Josepb A. McCahery & Erik P.M. Vermeulen, *Limited Partnership Reform in the United Kingdom: A Competitive, Venture Capital Oriented Business Form*, 5 EUR. BUS. ORG. L. REV. 61, 74–75 (2004) (suggesting that different corporate law and tax treatment may lead to competition for investments in the European Union). This Article reverses the focus. It argues that competition for investments is far more important than competition for incorporations as an explanation of corporate lawmaking in the European Union, and analyzes the fundamental differences between the two types of competition.

11. Competition for investments is different from yardstick competition—efforts by governments to satisfy voters by matching foreign corporate laws—in that it involves competition for mobile capital. For an analysis of yardstick competition in the European Union, see Pierre Salmon, *Political Yardstick Competition and Corporate Governance in the European Union*, *in* INVESTOR PROTECTION IN EUROPE: REGULATORY COMPETITION AND HARMONIZATION (Guido Ferrarini & Eddy Wymeerscb eds., forthcoming 2006).

12. Concomitantly, the European Court of Justice has limited the ability of member states to use tax incentives to stimulate their economies. *See generally* Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186 (2006).

tional way to attract investments.

A. CORPORATE LAW AS A COMPONENT OF A BUSINESS-FRIENDLY ENVIRONMENT

A time-honored method of attracting business is offering tax incentives. In the European Union, the Netherlands and Ireland are often linked with this practice,[13] but other member states do the same.[14] Yet tax breaks are not the only way to stimulate the economy. Many other inducements can achieve this end. The globalization of capital, product, and labor markets, together with the economic integration of the European Union, has made corporate law an important component of the business-friendly environment that lawmakers are expected to provide.[15] The reason, ironically, is that firms *do not* have the freedom to incorporate abroad. If member states are to attract investments in local companies, they must see to it that their law does not fall behind.[16]

13. *See* William W. Bratton & Joseph A. McCahery, *Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation*, 38 COMMON MKT. L. REV. 677, 701 (2001) (noting that Ireland and the Netherlands are known for their hospitable tax regimes); *Gimme Shelter: Is Tax Competition Among Countries a Good or a Bad Thing?*, THE ECONOMIST, Jan. 29, 2000 at Special Section 5–17 (reporting widespread tax competition around the world and naming Ireland, the Netherlands, and Luxembourg as the member states of the European Union engaged in tax competition).

14. For a discussion by corporate lawyers of the tax advantages their member states offer to companies, see generally, for example, Menelaos Kyprianou, *Cyprus as a Venue for the Establishment of a Holding Company*, 32 INT'L BUS. LAW. 66 (2004); Bente Møll Pedersen & Michael Hertz, *Legal Aspects of Acquiring a Publicly Traded Danish Company*, 28 INT'L BUS. LAW. 365, 368 (2000).

15. The term "corporate law" is used in this Article in a broad sense and includes both corporate governance and securities regulation. While in the United States the former is part of state law and the latter is part of federal law, in member states of the European Union the two are less distinct.

16. The ability to cross-list stock in a foreign jurisdiction with better law is not a sufficient alternative. First, it is unaffordable to many firms. Second, it does not guarantee enforcement of the foreign law on the cross-listed firm. *See* Jordan Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting U.S. Securities Law?*, 75 J. FIN. ECON. 319, 356 (2005) (arguing that reputation, rather than enforcement of the foreign law, constrains cross-listed firms). It is likely for this reason that the British takeover code applies only to companies that are both listed and headquartered in the United Kingdom. *See* THE PANEL ON TAKEOVERS & MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS, at A2–10 (7th ed. 2002) (U.K.), http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf. Moreover, cross-listing does not relieve firms of cumbersome legal institutions in their home jurisdiction. This is a significant drawback. In the relatively uniform landscape of state corporate laws in the United States, flexibility and efficient administration of corporate law tip the scales for incorporation decisions. *See* Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, J.L. ECON. & ORG. (forthcoming 2006) (presenting evidence suggesting that firms prefer states with flexible corporate statutes and effective courts). In the European Union, these attributes figure prominently in lawyers' discussions of foreign incorporations. *See* David F. Hickok & Thomas Schürrle, Debevoise & Plimpton, The "Inspire Art" Judgment of the European Court of Justice: New Ways to Structure Acquisitions in the European Union? 2–3 (2004) (client memorandum), http://www.debevoise.com/newseventspubs/publications (search keyword "Inspire Art" and follow hyperlink) (discussing the benefits for bilateral joint ventures of avoiding supermajority voting requirement for issuing new stock, and the benefits for private equity investors of avoiding restrictions on the issuance of redeemable or convertible preferred stock). Cross-listing can also force firms to comply with conflicting rules in their home jurisdiction and the cross-listing jurisdiction. *See* Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, 1 REV. L. & ECON. 97, 124–27 (2005) (discussing the conflict between the Sarbanes-Oxley Act of 2002 and corporate law in the European Union); Hal S.

This pressure did not exist several decades ago, when capital markets were segmented and investments were local. But the globalization of capital markets and the economic integration of the European Union have created a new reality in which member states cannot take investors for granted and cannot risk losing investments—including those by their own citizens—by keeping unattractive corporate laws that apply to any company conducting business within their borders. Between 1987 and 1996, for example, American investors nearly tripled the portion of foreign investments in their stock portfolios, from 3.8% to 10%, adding an important consideration to the political calculus of lawmakers in the European Union.[17] Between 1995 and 1999, the share of foreign investments by European investment funds increased from approximately 40% to close to 70%.[18] Their investments too could no longer be taken for granted.[19]

This transformation intensified competition for investments in a number of ways. First, it pressured firms to grow while depleting their internal cash reserves, forcing them to raise new capital or to use their stock as acquisition currency.[20] Second, it motivated firms to move production abroad to reduce costs, including costs associated with operating under the law of their home member state. Third, it shrank the profits into which managers could dip to extract private benefits, weakening their resistance to change.[21] Last, it prompted

Scott, *A Global Perspective on Corporate Governance*, CREDIT WEEK, Nov. 30, 2005, at 18, 20 (same). Finally, cross-listing can *reinforce* the competition for investments by driving securities professionals to endorse reform to avoid losing stock listing to a foreign jurisdiction. *See* John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1808–11 (2002) (describing lobbying by the securities industry in Brazil and Mexico to stem listing migration to the New York Stock Exchange).

17. *See* Linda L. Tesar & Ingrid M. Werner, *The Internationalization of Securities Markets Since the 1987 Crash*, *in* BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 281, 296 (Robert E. Litan & Anthony M. Santomero eds., 1998).

18. *See* Lieven Baele et al., *Measuring European Financial Integration*, 20 OXFORD REV. ECON. POL'Y. 509, 528 (2004). The share of foreign investments by these funds within Europe increased over that period from about 18% to about 30%. *See id.* at 529. The integration of European equity markets is also manifested in a tripling of the part of the variance of European stock returns explained by news common to all Europe from about 8% in 1973–1986 to about 23% in 1999–2003. *See id.* at 527. The part of the variance of European stock returns explained by American news doubled over that period from about 11% to about 20%, suggesting that European equity markets integration proceeded faster than global equity markets integration. *See id.* at 527 fig.12; *see also* Geert Bekaert et al., *Market Integration and Contagion*, 78 J. BUS. 39, 56 (2005) (reporting evidence of integration of equity markets within Europe and between Europe and the United States).

19. *See* FEDERATION OF EUROPEAN STOCK EXCHANGES, SHARE OWNERSHIP STRUCTURE IN EUROPE 3 (2002), http://www.fese.org/statistics/studies/share_ownership.pdf [hereinafter Share Ownership Survey] (reporting that globalization and the introduction of the euro have resulted in the emergence of foreign institutional investors as the driving force of European markets and in the increase of foreign holdings by domestic institutional investors).

20. A well-known example is the acquisition of United States carmaker Chrysler by German carmaker Daimler-Benz in 1998, which was helped by the fact that Daimler-Benz had switched to United States accounting principles prior to the acquisition. *See* Elizabeth MacDonald, *Proposed Deal Faces Rocky Road Due to Different Accounting Rules*, WALL ST. J., May 7, 1998, at A10.

21. *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 589–90 (2004) (arguing that product market competition lowers monopoly rents and

massive privatization, which depended on the quality of local corporate law.[22]

The agents of legal change varied across member states according to their institutional and political settings. In some member states, interest groups that would benefit from change openly demanded it. This was the case in Germany, where a new breed of investment banks lobbied for reform because they depended on the existence of a vibrant stock market.[23] In other member states, government officials acted as political entrepreneurs by personally pushing for change.[24] This was the case in Italy, where corporate reform was advanced by individuals in government.[25] And in all member states, institutional investors catalyzed reform by voicing their concerns.[26]

B. EXAMPLES

This Section offers examples of the impact that competition for investments

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leaves less room for extracting private benefits of control); Mark J. Roe, *Rents and their Corporate Consequences*, 53 STAN. L. REV. 1463, 1489 (2001) (arguing that the availability of monopoly rents helps to explain the persistence of weak shareholder protection in European corporate law).

22. The interest in corporate law taken by governments during privatization is illustrated by the frustration in the Italian government with the 1997 ouster of the Chairman of the privatized firm Telecom Italia by directors averse to reform. *See* Paul Betts & James Blitz, *At the Head of Italy's Table*, FIN. TIMES (London), Dec. 22, 1997, at 14 (quoting the Italian prime minister saying: "We are carrying out privatisations but we still have not done enough to create a proper financial market.... We do not have guarantees for small shareholders, no rules for public companies.").

23. *See* RICHARD DEEG, FINANCE CAPITALISM UNVEILED: BANKS AND THE GERMAN POLITICAL ECONOMY 90–93 (1999) (describing the transition of major German banks from lending to investment banking, the penetration of the German banking industry by foreign investment banks, and the lobbying by both groups of banks for corporate reform). Perhaps no German bank has changed more than Deutsche Bank, which has filled its top posts with U.S.-trained investment bankers and reduced corporate lending. *See* Janet Guyon, *The Trials of Josef Ackermann*, FORTUNE, Jan. 26, 2004, at 111. Recently, the chairman of its supervisory board joined the growing criticism of employee representation on supervisory boards. *See Deutsche Bank Sichtet Fusionskandidaten* [*Deutsche Bank Looks for Merger Candidates*], FRANKFURTER ALLGEMEINE ZEITUNG, June 5, 2004, at 11 (F.R.G.).

24. *See* RUSSEL HARDIN, COLLECTIVE ACTION 35–37 (1982) (discussing political entrepreneurs as public figures who advance their own careers by promoting a certain public or group interest).

25. *See* Richard Deeg, *Remaking Italian Capitalism? The Politics of Corporate Governance Reform*, 28 W. EUR. POL. 521, 529 (2005) (listing government officials who played key roles in corporate reform). Thus, in a 1998 article titled *Corporate Governance and Competitiveness*, Treasury Director, Commissioner of Privatization, and drafter of the new corporate code Mario Draghi described his vision of corporate law and financial regulation as drivers of national economic growth through "increasingly competitive market rules and standards of company law" where "the ability of national enterprises to raise funds will depend to an ever greater extent on the efficiency of Italy's 'financial centre' and the 'quality' of the products, representing administrative as well as property rights, that are traded." *See* Mario Draghi, *Corporate Governance and Competitiveness*, SEPT.–DEC. 1998 REV. ECON. CONDITIONS IN ITALY 341, 344 (1998).

26. Institutional investors vote with their feet against countries with inadequate law. *See* Kalok Chan et al., *What Determines the Domestic Bias and Foreign Bias? Evidence from Mutual Fund Equity Allocations Worldwide*, 60 J. FIN. 1495, 1527 (2005); Mariassunta Giannetti & Yrjö Koskinen, *Investor Protection and the Demand for Equity* 31 (Eur. Corp. Gov. Inst.-Fin. Research Paper Series, Working Paper No. 64/2004, Dec. 2004), *available at* http://ssrn.com/abstract=554522; Christian Leuz et al., *Do Foreigners Invest Less in Poorly Governed Firms?* 29 (Eur. Corp. Governance Inst.–Fin. Research Paper Series, Working Paper No. 43/2004, Feb. 2005), *available at* http://ssrn.com/abstract=512042.

has had on member state legislation in recent years.[27] The legal innovation and diffusion described in these examples is not the product of competition for incorporations. Even commentators who predict such competition in the European Union acknowledge its absence today, and regard large industrialized member states as unlikely candidates to spearhead it.[28] Yet it is these large member states that seem to have adopted the most sweeping legal reforms. Far from trying to win new incorporations or to retain existing ones (neither of which can motivate laws applicable only to local businesses), member states modified their laws to attract investments into their economies. Sometimes they innovated. Often they borrowed from others.[29]

1. Germany

Germany began its journey to shareholder capitalism in the second half of the 1980s as part of a campaign to make the country a desirable place for production ("*Wirtschaftsstandort Deutschland*"),[30] which later mutated into a campaign to strengthen the country's position as a financial center ("*Finanzplatz Deutschland*").[31] Early reforms were designed to modernize the existing platforms for securities trading. These reforms included the introduction of electronic trading on the national stock exchange in 1986,[32] amendments to the stock exchange law in 1989,[33] the elimination of taxes on stock trading in 1989,[34] and the opening of a futures exchange in 1990.[35]

A series of laws to liberalize securities trading while tightening investor

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27. *See, e.g.*, Matthew Valencia, *Good Heavens, Good Governance*, THE ECONOMIST, Apr. 29, 2000, at S13 (quoting the editor of a corporate governance newsletter referring to an "enormous uptick" in both legislation and practice in continental Europe during the previous year).

28. *See* Dammann, *supra* note 5, at 530–31; Hertig & McCahery, *supra* note 5, at 187.

29. In some cases, member states copied foreign law at local companies' request. In 1998, for example, Germany passed a law (Kapitalaufnahmeerleichterungsgesetz, or KapAEG) allowing companies to balance their books using international or American accounting standards to enable listing stock overseas without having to prepare two sets of financial statements. *See* Eric Nowak, *Recent Developments in German Capital Markets and Corporate Governance*, 14 J. APPLIED CORP. FIN. 35, 44 (2001) (linking the legislation to the listing of Daimler-Benz in the United States as part of its merger with Chrysler).

30. *See* Martin Höpner, *European Corporate Governance Reform and the German Party Paradox* 20 (Max-Planck-Institut für Gesellschaftsforschung, Discussion Paper 03/4, Mar. 2003), *available at* http://www.mpi-fg-koeln.mpg.de/pu/mpifg_dp/dp03-4.pdf.

31. *See* Jürgen Beyer & Martin Höpner, The Disintegration of Organised Capitalism: German Corporate Governance in the 1990s, 26 W. EUR. POL. 179, 191 (2003).

32. *See* Richard Deeg, *Change from Within: German and Italian Finance in the 1990s*, *in* BEYOND CONTINUITY: INSTITUTIONAL CHANGE IN ADVANCED POLITICAL ECONOMIES 169, 180 (Wolfgang Streeck & Kathleen Thelen eds., 2005).

33. *See id.*

34. *See* Gesetz zur Stärkung des Finanzplatzes Deutschland [Law Bolstering the Financial Center Germany], *also known as* Erstes Finanzmarktförderungsgesetz [First Financial Market Promotion Law], July 11, 1989, BGBl. I at 1412 (F.R.G.); Eric Nowak, *Investor Protection and Capital Market Regulation in Germany*, *in* THE GERMAN FINANCIAL SYSTEM 425, 429 (Jan Pieter Krahnen & Reinhard H. Schmidt eds., 2004).

35. *See* Deeg, *supra* note 32, at 180.

protection followed. They included a 1990 law requiring corporate issuers to prepare an offering prospectus;[36] a 1994 law banning insider trading, introducing disclosure obligations, and establishing a new securities agency charged with regulation and enforcement;[37] a 1998 law allowing companies to use American or international accounting standards;[38] a 1998 law deregulating investment funds;[39] and a 1998 law broadening disclosure obligations, authorizing stock option compensation, expanding the responsibilities of supervisory boards, limiting voting by banks, requiring shares to have equal voting rights, and strengthening auditor independence.[40]

The reform continued with a 2000 law using a capital gains tax exemption to encourage banks to liquidate their stock holdings;[41] a 2001 law regulating takeovers;[42] a 2002 law criminalizing market manipulation, requiring disclosure

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36. *See generally id.*; Gesetz über Wertpapier-Verkaufsprospekte und zur Änderung von Vorschriften über Wertpapiere [Law Governing Sales Prospectuses for Securities and Revising Securities Regulation], Dec. 13, 1999, BGBl. I at 2749 (F.R.G.).

37. *See* Zweites Finanzmarktförderungsgesetz [Second Financial Market Promotion Law], July 26, 1994, BGBl. I at 1749 (F.R.G.); Nowak, *supra* note 34, at 429–33. In 2002, the agency was combined with the banking and insurance agencies to form a single financial services agency. *See* Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht [Law Establishing the Federal Financial Supervisory Authority], Apr. 22, 2002, BGBl. I at 1310 (F.R.G.).

38. *See* Gesetz zur Verbesserung der Wettbewerbsfähigkeit deutscher Konzerne an Kapitalmärkten und zur Erleichterung der Aufnahme von Gesellschafterdarlehen [Law for Improving the Competitiveness of German Companies in Capital Markets and Facilitating the Taking of Loans by Shareholders], *also known as* Kapitalaufnahmeerleichterungsgesetz [KapAEG, Capital Raising Facilitation Law], Apr. 20, 1998, BGBl. I at 707 (F.R.G.); Nowak, *supra* note 34, at 435. For the positive response to the law in business circles, see generally Martin Glaum, *Bridging the GAAP: The Changing Attitude of German Managers Towards Anglo-American Accounting and Accounting Harmonization*, 11 J. INT'L FIN. MGM'T & ACCT. 1 (2000).

39. *See* Drittes Finanzmarktförderungsgesetz [Third Financial Market Promotion Law], Mar. 29, 1998, BGBl. I at 529 (F.R.G.); Nowak, *supra* note 34, at 434–35.

40. *See* Gesetz zur Kontrolle und Transparenz im Unternehmensbereich [KonTraG, Law on Control and Transparency in Business Enterprises], Apr. 27, 1998, BGBl. I at 786 (F.R.G.); Nowak, *supra* note 34, at 435–37.

41. *See* Gesetz zur Senkung der Steuersätze und zur Reform der Unternehmensbesteuerung [Law on the Reduction of Tax Rates and Reform of Business Taxation], *also known as* Steuersenkungsgesetz [StSenkG, Tax Reduction Law], Oct. 23, 2000, BGBl. I at 1433 (F.R.G.); Nowak, *supra* note 34, at 437–38.

42. *See* Wertpapiererwebs-und Übernahmegesetz (WpÜG) [Securities Acquisition and Takeover Law], Dec. 20, 2001, BGBl. I at 3822 (F.R.G.). Responding to management concerns raised by the takeover of German telephone company Mannesmann by British rival Vodafone a year earlier, the law authorized supervisory boards to resist takeovers. *See* Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the EU: The German Example*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 541, 541–59 (Guido Ferrarini et al. eds., 2004). Many other aspects of the law, however, such as the mechanism for cashing out minority shareholders, have streamlined takeovers and prompted legal practitioners to describe the law as "a critical step toward a fairer, more open environment for potential acquirors of German public companies," which "appears to signal foreign investors that German capital markets are now ready to treat unsolicited tender offers, sophisticated LBOs and other going-private transactions as routine." *See* Skadden, Arps, Slate, Meagher & Flom LLP, New German Takeover Scheme: Reshaping Germany's Market for Corporate Control 1 (Apr. 2002) (client memorandum), http://www.skadden.com/content/publications/809library.pdf.

of director trading, and creating a private right of action for securities fraud;[43] a 2002 law requiring public companies to follow a code of corporate governance or disclose their failure to do so;[44] a 2004 law modifying various areas of securities law;[45] a 2005 law on shareholder class actions;[46] and a 2005 law on shareholder derivative lawsuits.[47]

The British and American influence on these reforms is evident. Yet their goal was to boost economic growth, not to attract incorporations.[48] Apart from aiming to make Germany a financial center, the reforms responded to corporate failures that were blamed on bank-dominated corporate boards asleep at the switch.[49] The reforms also were part of a transition to shareholder capitalism signaled by the ambitious privatization of Deutsche Telekom in 1996.[50] And, with the German government's effort to overhaul the country's ailing pension system in 2001 by encouraging private savings for retirement, the reforms

43. *See* Viertes Finanzmarktförderungsgesetz [Fourth Financial Market Promotion Law], June 21, 2002, BGBl. I at 2010 (F.R.G.); Nowak, *supra* note 34, at 439–40.

44. *See* Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität [Law to further Reform Stock Corporation and Accounting Legislation on Transparency and Disclosure], *also known as* Transparenz- and Publizitätsgesetz [TransPuG, Transparency and Disclosure Law], July 19, 2002, BGBl. I at 2681 (F.R.G.).

45. *See* Gesetz zur Verbesserung des Anlegerschutzes [AnSVG, Investor Protection Improvement Law], Oct. 28, 2004, BGBl. I at 2630 (F.R.G.).

46. *See* Gesetz über Musterverfahren in kapitalmarktrechtlichen Streitigkeiten [Law on Model Case Proceedings in Disputes under Capital Markets Law], *also known as* Kapitalanleger-Musterverfahrensgesetz [KapMuG, Capital Markets Model Case Law], Aug. 10, 2005, BGBl. I at 2437 (F.R.G.).

47. *See* Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts [UMAG, Law on Corporate Integrity and Modernization of Rescission Proceedings], Sept. 22, 2005, BGBl. I at 2802 (F.R.G.).

48. *See generally* Theodor Baums, *Company Law Reform in Germany*, 3 J. CORP. LEGAL STUD. 181, 181–82 (2003) (noting that the reasons for Germany's corporate law reform were corporate scandals involving German companies, the need to reconcile the law with foreign law that applies to cross-listed German companies, the need to meet the expectations of foreign institutional investors who buy shares of German companies, the transformation of the German pension system into one partly based on institutional investors managing privately-invested capital, competition among regulators to offer corporate law that meets the need of the market, and the need to offer flexibility to German companies financed by venture capital); Janet Guyon, *The Trials of Josef Ackermann*, FORTUNE, Jan. 26, 2004, at 111 (noting that Germany is "struggling to liberalize its labor laws, overhaul its pension system, cut unemployment benefits, and reform its corporate governance rules in order to boost growth, which was flat in 2003").

49. *See* Jeffrey N. Gordon, *Pathways to Corporate Governance? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 COLUM. J. EUR. L. 219, 220–21 (1999) (describing the board failures at Daimler-Benz, Metallgesellschaft, Schneider, and Klöckner-Humboldt-Deutz that precipitated the 1998 reform); Nowak, *supra* note 34, at 433–34, 438–39 (noting that the 2002 reform was partly a response to the scandals that had brought down in 2001 the Neuer Markt, the Frankfurt Stock Exchange's trading platform for high-growth companies).

50. *See* Jeffrey N. Gordon, *An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union*, 1990–2000 (Eur. Corp. Governance Inst. Law Working Paper No. 6/2003; Harvard Law Sch. Ctr. for Law, Econ. & Bus., Discussion Paper No. 406, Feb. 2003), *available at* http://ssrn.com/abstract=374620 (linking the expansion of stock ownership in public companies, the launch of a stock trading platform for young companies, the tightening of legal protection of shareholders, and the growing acceptance of a market for corporate control to the privatization of Deutsche Telekom in 1996).

raised the profile of the stock market as a viable avenue for investment.[51] All of these objectives pushed lawmakers to meet shareholder needs.

Consider, for example, the corporate governance code that public companies were required to follow.[52] The code was the work of a commission formed by the government to propose how to modernize corporate law in light of the globalization of capital markets.[53] The commission did not disband after handing over its report. It continues to monitor and periodically update the corporate governance code, and maintains a website in German, English, French, Italian, and Spanish on corporate governance in Germany.[54] The multilingual site fits the purpose of the code. "The aim of the German Corporate Governance Code," the site explains, "is to make Germany's corporate governance rules transparent for both national and international investors, thus strengthening confidence in the management of German corporations."[55]

The same objective underlies the law on derivative suits.[56] Here too, according to the financial press, there is no doubt about the motivation for reform: "[A]s corporate Germany opens its shareholder registers to the world, the government has realised the old order has to change. It is rushing a vast package of reforms through parliament to overhaul companies' relations with investors."[57]

2. Italy

The transformation of Italian corporate law began in 1990 with the Amato Law, named after the Treasury Minister who sponsored it, which incorporated all state-controlled hanks in preparation for their privatization.[58] It was followed

51. *See* Sigurt Vitols, *Changes in Germany's Bank-Based Financial System: Implications for Corporate Governance*, 13 CORP. GOV. 386, 390 (2005) (noting that the overhaul sought to increase investment in Germany's capital markets).

52. *See supra* note 44 and accompanying text.

53. According to the bill that adopted the commission's recommendations, the commission had been asked to propose how to modernize the law in light of the globalization of capital markets. *See* BTDRUCKS. 14/8769, at 10 (F.R.G.), *available at* http://dip.bundestag.de/btd/14/087/1408769.pdf ("[S]ollte sie im Hinblick auf den durch Globalisierung und Internationalisiernng der Kapitalmärkte sich vollziehenden Wandel unserer Untemehmens- und Marktstrukturen Vorschläge für eine Modernisierung unseres rechtlichen Regelwerkes unterbreiten.").

54. *See* Government Commission in the German Corporate Governance Code, http://www.corporate-governance-code.de/index-e.html (last visited June 7, 2006). The code has thus far been amended thrice. *See id.*, http://www.corporate-governance-code.de/eng/archiv/index.html (last visited June 7, 2006) (displaying previous versions).

55. *See id.*, http://www.corporate-governance-code.de/index-e.html. This is consistent with the bill that introduced the 2002 law, which noted that, "especially for informing foreign investors, it appeared inevitable to adopt a corporate governance code for Germany." *See* BTDRUCKS. 14/8769, at 21 ("Gerade im Hinblick auf die Information ausländischer Anleger erschien es unvermeidlich, einen maβgebenden Corporate-Governance-Kodex für Deutschland zu initiieren.").

56. *See supra* note 47.

57. Bertrand Benoit & Patrick Jenkins, *Germany Looks to Call Time on Its Business War Games*, FIN. TIMES (London), Dec. 30, 2004, at 32.

58. *See* Law No. 218, July 30, 1990, Gazz. Uff. No. 182, Aug. 6, 1990 (Italy).

in 1992 by the conversion of other state-controlled businesses to corporations.[59] The privatization plan had two objectives, both related to the economic integration of the European Union. The first objective was to facilitate the consolidation of the Italian industry in order to compete with foreign businesses.[60] The second objective was to lower the national deficit in order to qualify for admission into the euro system.[61] The privatizations started in 1993 and peeked in 1997 with the public offering of Telecom Italia and Borsa Italiana.[62]

In the same year, the government formed a committee to draft a new public company law and appointed the Commissioner of Privatizations, Mario Draghi, as its chair. The resulting legislation, enacted in 1998, revamped the law governing public companies. Coming at the heels of a recent tax reform to encourage public equity offerings,[63] it introduced new disclosure obligations, strengthened shareholder rights, facilitated voting by proxy, and expanded the enforcement power of the securities authority.[64]

The following years saw further legislation—in the form of a 2001 law and four decrees to implement it—vastly expanding the flexibility that both public and private companies have in financing and structuring their operations.[65] Among other things, the legislation allowed for different board structures; limited the ability of shareholders to bring strike suits; authorized the issuance of preferred stock, redeemable stock, tracking stock, bonds of any kind, and

59. *See* Deeg, *supra* note 32, at 187. The need to compete with foreign banks resulted from the European Union Investment Services Directive, which required member states to allow foreign banks to operate inside their borders. *See id.*

60. *See id.*

61. *See, e.g.*, Niccolo d'Aquino, *Italy Prepares for EMU*, 368 EUROPE 14 (1997) (noting that Italy's ability to meet the euro qualification criteria is "repeated everyday in the newspapers," that the Prime Minister and his coalition members "are betting all their international—and a great deal of their national—credibility on whether or not they can do it," and that "what counts most is the first and most important parameter: the percentage of the public deficit with regard to the gross national product"); *Romano Prodi, Italy's Would-Be Record-Breaker*, THE ECONOMIST, Oct. 10, 1998, at 58 (noting that Italian Prime Minister Prodi, formerly an economics professor, "pushed ahead with privatisation . . . [,] liberalised shopping hours and licences, tried to shake the fat out of the economy, and made bureaucrats jump" to meet the euro qualification criteria).

62. *See* Deeg, *supra* note 32, at 188. In addition to adding the public float on the market, the privatization of Borsa Italiana created a powerful new supporter of corporate reform. *See id.*

63. *See* Paul Betts, *Market Half the Size It Should Be*, FIN. TIMES (London), Dec. 10, 1997, at 2.

64. *See* Alexander Aganin & Paolo Volpin, *The History of Corporate Ownership in Italy*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 325 (Randall K. Morck ed., 2005); Deeg, *supra* note 32, at 188; Guido A. Ferrarini, *Corporate Governance Changes in the 20th Century: A View from Italy*, *in* CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US 31, 46–48 (Klaus J. Hopt, Eddy Wymmersch, Hideki Kanda & Harald Baum eds., 2005).

65. *See* Law No. 366, Oct. 3, 2001, Gazz. Uff. No. 234, Oct. 8, 2001 (Italy); Decree-Law No. 61, Apr. 11, 2002, Gazz. Uff. No. 88, Apr. 15, 2002 (Italy); Decree-Law No. 5, Jan. 17, 2003, Gazz. Uff. No. 17, Supp. Ord. 8, Jan. 22, 2003 (Italy); Decree-Law No. 6, Jan. 17, 2003, Gazz. Uff. No. 17, Supp. Ord. 8, Jan. 22, 2003 (Italy); Decree-Law No. 37, Feb. 6, 2004, Gazz. Uff. No. 37, Supp. Ord. 24, Feb. 14, 2004 (Italy).

hybrid securities; and facilitated shareholder voting.[66]

To Italian commentators it is obvious that all these changes were inspired by foreign laws.[67] But the changes were not meant to attract incorporations. Rather, in the words of one Italian Treasury official, their objective was

> to enhance the competitiveness of Italian companies and enhance their efficiency and their ability to grow in an increasingly competitive environment, working on the assumption that global competition not only involves a country's economic conditions, but also the legal system in which companies operate. For when investors decide how to allocate the resources they manage, they assess both the economic factors and the reliability and accountability of the legal system, as well as the management of individual companies.[68]

These words are echoed in the 2001 law itself, which states as its goal to promote the birth, the growth, and the competitiveness of enterprises through access to domestic and international capital markets.[69]

In 2005, the Italian parliament adopted an investor protection law prompted by the collapse of dairy producer Parmalat two years earlier.[70] The conceptual framework of the law is reminiscent of legislation introduced in the United States in the wake of the Enron debacle two years earlier. However, Italy's lawmakers had different motives. Whereas, the American legislation has been viewed as a political reflex to placate voters with little concern for how foreign issuers would react to the changes,[71] the Italian law has been seen as an attempt

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66. For details of the reforms, see generally Guido Ferrarini, Paolo Giudici & Mario Stella Richter, *Company Law Reform in Italy: Real Progress?*, 69 Rabels Zeitschrift fuer auslaendisches und internationales Privatrecht 658 (2005) (F.R.G.); Paolo Montalenti, *The New Italian Corporate Law: An Outline*, 1 EUR. CO. & FIN. L. REV. 368 (2004).

67. *See* Marco Ventoruzzo, *Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, 40 TEX. INT'L L.J. 113, 114 (2004); Ferrarini, Giudici & Richter, *supra* note 66.

68. Roberto Ulissi, Company Law Reform in Italy: An Overview of Current Initiatives 2 (unpublished manuscript, presented at the Conference on Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends), *available at* http://www.oecd.org/dataoecd/21/32/1857507.pdf. Elsewhere, that author reiterates, "Making Italy a more attractive environment for investors can be considered the idea lying behind the reform initiatives: this has meant revising securities, company and bankruptcy law. The judicial mechanism for enforcing shareholders' and creditors' rights also need [sic] to be improved." *Id.*

69. *See* Law No. 366, art. 2(1)(a), Oct. 3, 2001, Gazz. Uff. No. 234, Oct. 8, 2001 (Italy) ("La riforma del sistema delle società di capitali . . . è ispirata ai . . . perseguire l'obiettivo prioritario di favorire la nascita, la crescita e la competitività delle imprese, anche attraverso il loro accesso ai mercati interni e internazionali dei capitali.").

70. *See* Law No. 262, Dec. 28, 2005, Gazz. Uff. 301, Dec. 28, 2005 (Italy); Cleary, Gottlieb, Steen & Hamilton, Reform of Italian Corporate and Securities Law: The Investor Protection Act (Mar. 6, 2006) (client memorandum), http://www.cgsh.com/files/tbl_s5096AlertMemoranda/FileUpload5741/355/19-2006.pdf.

71. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1525–26 (2005) (presenting a Gallup poll that reflects public opinion of confidence in Big Business).

to repair the country's reputation among investors.[72]

3. France

The development of French corporate law is also linked to the massive privatizations that started in 1986 and increased the dependence of the economy on equity markets. The reform's opening shot was fired in 1984 with a law enhancing the independence of corporate auditors.[73] Drawing political force from two financial scandals involving state-owned aluminum company Pechiney and recently privatized bank Société Générale, the reform continued with a 1988 law that expanded the enforcement powers of the country's securities agency; created two additional securities agencies; and imposed new disclosure, manipulation, and insider-trading rules.[74] A 1989 law further strengthened the enforcement powers of the securities agency.[75] The next step was a 2001 law which improved corporate disclosure, facilitated shareholder litigation, enhanced shareholder protection in takeovers, and allowed companies to separate the roles of chief executive officer and chair of the board.[76] The government-commissioned report on which the reform was based was clear about its motivation:

> Economic competition also puts in competition legal systems. From this perspective, the heavy-handedness and rigidities of French corporate law are a handicap. Among the considerations taken into account in the choice of the host country for a commercial company, the adaptability of the law to the specific needs of the company and to changes in the economic and social environment is undoubtedly an important factor.[77]

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72. *See Not So Super Consob*, THE ECONOMIST, Feb. 7, 2004, at 78 (reporting that the government "is keen to rush through a new law to reform financial regulation in Italy because of the collapse of Paramalat," which "destabilised Italy's fragile banking sector and left the reputation of the country as a wise place in which to invest more than a little dented"); *Turning Sour*, THE ECONOMIST, Jan. 3, 2004, at 8 (discussing effects of Parmalat scandal).

73. *See* James A. Fanto, *The Role of Corporate Law in the Adaptation of French Enterprises*, 1998 COLUM. BUS. L. REV. 97, 112 ("French legal policy-makers substantially modified the law in 1984 to increase the verification responsibilities of the commissaire and to ensure his or her independence from management.").

74. *See* Leslie A. Goldman, Note, *The Modernization of the French Securities Markets: Making the EEC Connection*, 60 FORDHAM L. REV. S227, S237–40 (1992) ("This law broadened the COB's oversight responsibilities by rendering the Commission responsible for the proper functioning of the Bourse and the Matif . . . and expanded the definition of insider trading to include transactions involving futures contracts. The 1998 law also modified the structure of the regulatory system by establishing the CBV and SBF.").

75. *See id.*

76. *See* Law No. 2001-420 of May 15, 2001, Journal Officiel de la République Française [J.O.] [Official Gazette of France], May 16, 2001, p. 7776.

77. *See* PHILIPPE MARINI, LA MODERNISATION DU DROIT DES SOCIÉTÉS 20 (1996) (Rapport au Premier Ministre, July 13, 1996) [Report to the Prime Minister on the Modernization of Corporate Law] (Fr.) ("[L]a compétition économique met également en concurrence les systèmes juridiques. De ce point de vue, la lourdeur et les rigidités du droit français des sociétés constituent un handicap. Parmi les éléments pris en considération dans le choix du pays d'accueil d'une société commerciale, nul doute

In 2003, another law came into effect in France which transformed three corporate regulatory agencies with shared responsibilities into a single body.[78] According to French lawyers, one of the goals of the change was to "help restore investors' confidence in the financial markets in the wake of recent U.S. and European financial scandals."[79]

Confidence in the market, however, was not enough. Investments also required flexibility. And flexibility is what the legislature sought to provide in an ordinance signed by the French President in 2004.[80] That ordinance removes procedural constraints on seasoned stock offerings, enables issuers to define the terms of preferred stock, and simplifies the treatment of convertible stock.[81]

4. The United Kingdom

In 2005, the British government introduced a bill to revamp the country's corporate law.[82] The bill is based on a comprehensive review commissioned in 1998 by the Department of Trade and Industry "to develop a simple, modern, efficient and cost effective framework for carrying out business activity in Britain for the twenty-first century."[83] Tellingly, while the initiative originally

que la faculté d'adaptation de l'instrument juridique aux besoins spécifiques de l'entreprise et aux modifications de l'environment économique et social soit un factuer important."); *see also id.* at 6 ("[l]l faut à présent envisager d'assurer la compétitivité juridique de la France par rapport aux systèmes d'inspiration anglo-saxonne d'un côté et germanique de l'autre, dans le contexte de marchés financiers totalement interconnectés et d'une liberté de plus en plus large de localisation des activités économiques." [It is now necessary to plan to ensure the legal competitiveness of France relative to Anglo-American systems on the one hand and German systems on the other hand, in the context of completely interconnected financial markets and increasingly broad freedom where to place economic activity.]).

78. *See* Law No. 2003-706 of Aug. 1, 2003, Journal Officiel de la République Française [J.O.] [Official Gazette of France], Aug. 2, 2003, p. 13220.

79. *See* Nicolas Bombrun & François Mary, *France*, *in* THE INTERNATIONAL FINANCIAL LAW REVIEW GUIDE TO MERGERS AND ACQUISITIONS 2004, *available at* http://www.iflr.com/?Page=17&ISS=16378&SID=515244.

80. *See* Ordinance No. 2004-604 of June 24, 2004, Journal Officiel de la République Française [J.O.] [Official Gazette of France], June 26, 2004, p. 11612.

81. *See* Cleary, Gottlieb, Steen & Hamilton, France Adopts New Legislation to Modernize its Securities Laws (July 8, 2004) (client memorandum), http://www.cgsh.com/files/tbl_s5096AlertMemoranda%5CFileUpload5741%5C188%5C55-2004.pdf.

82. *See* Company Law Reform Bill, 2005 H.L. Bill [34] (U.K.).

83. *See* Dept. of Trade & Indus., Company Law Reform Bill (U.K.), http://www.dti.gov.uk/bbf/co-law-reform-bill/clr-review/page22794.html (last visited June 7, 2006). The reform was presented as part of a broader policy of "promoting enterprise and raising productivity" by fitting corporate law "for the twenty-first century and beyond." *See* Patricia Hewitt, *Preface by the Secretary of State* to DEP'T OF TRADE & INDUS.'s MODERNISING COMPANY LAW, 2002, Cm. 5553, at 3 (U.K.), *available at* http://www.dti.gov.uk/companiesbill/prelims.pdf; *see also* Kevin Brown & Michael Peel, *Blueprint to Help Bring Business 'Into 21st Century'*, FIN. TIMES (London), July 27, 2001, at 4 (reporting that the trade and industry Secretary explained the need for the reform by saying that "UK company law, once regarded as the best in the world, has fallen well behind that of other countries" and that "[y]ears of neglect have left us with an archaic Victorian system that is holding British business back"). The initiative received industry support. *See id.* (reporting support by the Institute of Directors and the Trade Union Congress).

highlighted small private companies,[84] the reforms that have been implemented so far target public companies, which are more relevant to internationally mobile capital.[85] These reforms include regulations from 2002 requiring public companies to disclose executive compensation and have shareholders approve it,[86] an act from 2004 strengthening the audit of public companies while expanding the power of companies to indemnify directors for liability,[87] and regulations from 2005 (which have since been repealed[88]) requiring public companies to disclose more fully their performance and business risks.[89]

5. Other Member States

Examples from other member states abound.[90] In 1999, for example, a takeover law modeled after the British City Code on Takeovers came into effect in Austria. The law was not meant to attract incorporations. Accordingly, it applies only to companies located and listed in Austria.[91]

Similarly, in 2004, the Dutch parliament enacted a law setting forth new requirements regarding the election of directors, shareholder approval for major corporate changes, shareholder proposals, and voting by holders of share depository receipts. The impetus for the reform was not a government plan to attract foreign incorporations, but rather a series of major domestic bankruptcies, financial scandals, and lavish executive compensation packages that resulted in a public uproar.[92] The reform was nonetheless informed by solutions given elsewhere in the world to similar problems. In particular, according to Dutch commentators, it reflected increasing sensitivity to the need for independence in

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84. *See* DEP'T OF TRADE & INDUS., MODERNISING COMPANY LAW, 2002, Cm. 5553 (U.K.), at 15–16, *available at* http://www.dti.gov.uk/companiesbill/part2.pdf.

85. *See* Eilís V. Ferran, *The Company Law Reform in the United Kingdom: A Progress Report*, 69 RABELS ZEITSCHRIFT FUER AUSLAENDISCHES UND INTERNATIONALES PRIVATRECHT 629, 641–52 (2005) (F.R.G.) (discussing recent legislative developments and proposals).

86. *See* Directors' Remuneration Report Regulations, 2002, S.I. 2002/1986 (U.K.).

87. *See* Companies (Audit, Investigations and Community Enterprise) Act, 2004 (U.K.). According to the official notes to the act, it "forms part of the Government's strategy to help restore investor confidence in companies and financial markets following recent major corporate failures." *See* DEP'T OF TRADE & INDUS., EXPLANATORY NOTES TO COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT, 2004, ¶ 4 (U.K.), *available at* http://www.opsi.gov.uk/acts/en2004/2004en27.htm.

88. *See* Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005, S.I. 2005/3442 (U.K.).

89. *See* Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005, S.I. 2005/1011 (U.K.).

90. For a survey of corporate reforms in twenty-one European countries prepared for the British Department of Trade and Industry, see CTR. FOR LAW & BUS., UNIV. OF MANCHESTER, COMPANY LAW IN EUROPE: RECENT DEVELOPMENTS (1999), *available at* http://www.dti.gov.uk/cld/milman.pdf.

91. *See* Nick Callister-Radcliffe, *Rejection of the EU Takeover Directive—The Implications*, 29 INT'L BUS. LAW. 337, 339–40 (2001); Peter M. Polak, *Austria*, *in* THE INTERNATIONAL FINANCIAL LAW REVIEW GUIDE TO MERGERS AND ACQUISITIONS 2004, *available at* http://www.iflr.com/?Page=17&ISS=16378&SID=515234.

92. *See* Jan Louis Burggraff & Joyce Winnubst, *The Netherlands*, *in* THE INTERNATIONAL FINANCIAL LAW REVIEW GUIDE TO MERGERS AND ACQUISITIONS 2004, *available at* http://www.iflr.com/?Page=17&ISS=16378&SID=515251.

conducting corporate audits "[d]ue to international developments (the Sarbanes-Oxley Act, IAS/IFRS, and various financial scandals such as Enron, Parmalat and Ahold)."[93]

Finally, consider voluntary codes of corporate governance. By the end of 2001, there were no less than thirty-five codes setting similar best practices of corporate governance in the various member states of the European Union; twenty-five of these codes were issued after 1997.[94] Subsequent years saw the introduction of additional voluntary codes. They too resembled each other in their handling of executive compensation, financial auditing, and public disclosure.[95]

II. THE INCENTIVES TO COMPETE

The ability and willingness of corporate decisionmakers to shop for laws is not sufficient for regulatory competition to develop. Another key condition is a desire by lawmakers to respond. But this condition is not easily met. In the United States, only Delaware pursues incorporations by foreign firms. Other states, by some accounts, make far weaker efforts to retain incorporations by local firms and, by other accounts, do not compete at all. In contrast, the incentives to compete for investments can be strong because the rewards are high and because these rewards accrue to all competitors rather than to only one. The integration of the markets for capital, products, and labor in recent years has set the stage for this competition to develop in the European Union. The dramatic response by member states leaves no doubt about the ability of competition for investments to shape corporate law.

A. BENEFITS

An important reason why competition for investments thrives where competition for incorporation might fail to get lawmakers' attention is that its rewards are higher and more suitable to becoming part of a political platform.[96]

1. Competition for Incorporations

Much has been said about the lure of fiscal gains that a jurisdiction can earn

93. *See id.*

94. *See* Weil, Gotshal & Manges, COMPARATIVE STUDY OF CORPORATE GOVERNANCE CODES RELEVANT TO THE EUROPEAN UNION AND ITS MEMBER STATES 2 (2002), http://europa.eu.int/comm/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf.

95. For a detailed list of codes by country, see European Corporate Governance Institute, Index of Codes, http://www.ecgi.org/codes/all_codes.php (last visited June 7, 2006).

96. Another difference between competition for incorporations and competition for investments is that only the former can theoretically be replicated by private actors. The politics involved in any public lawmaking have led commentators to conclude that private actors competing for incorporations would produce better corporate law than would elected officials. *See generally* Gillian Hadfield & Eric Talley, *On Public Versus Private Provision of Corporate Law*, 22 J.L. ECON & ORG. (forthcoming 2006). Private actors, however, cannot capture the gains from economic development, and thus they cannot replicate the competition for investments.

from incorporations by foreign companies and about the profits its legal community can reap from providing services to these companies. In reality, however, only jurisdictions with limited financial means can be moved by the possible fiscal gains from incorporations. And the legal community, as enthusiastic as it may be about attracting incorporations, must point to significant gains accruing to the entire polity in order to motivate lawmakers to adopt corporate legislation that could face significant opposition.

It is difficult to estimate the potential of incorporations as a source of tax revenue. Any such estimate depends on the number of incorporated firms, their need of corporate law, and the alternatives available to them elsewhere. It is easy, however, to observe the experience that Delaware has had in this regard. Delaware is a success story. It stands in the enviable position of attracting half the public companies in the United States[97] and almost all public companies that incorporate outside their home state[98]—with virtually no political costs and only minimal financial costs. The result? A respectable tax revenue of $523 million forecasted for 2005 on budgeted outlays of $13 million, constituting a fifth of the state's revenue.[99]

But tbis American dream may remain out of reach for member states of the European Union even as the freedom to choose where to incorporate reaches their shores. Taxing incorporated firms more than the cost of servicing them is simply not allowed under European Union law.[100] Not that such a tax would make a big difference. In 2004, the gross domestic product in the United States was $11.7 trillion. The equivalent figure for the European Union was $9.6 trillion.[101] Domestic stock market capitalization in the United States in that year was $16.3 trillion. The corresponding figure for the European Union was $8

97. *See* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1813 (2002) (examining Delaware's share of American public companies in 2000). Delaware public companies also tend to be bigger than other public companies. While constituting half the public companies in the sample, they account for fifty-nine percent of net sales. *See id.*

98. *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 386 (2003) (arguing that Delaware's "dominance of this market is greater than is commonly recognized"); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1562 (2002) (examining Delaware's share of initial public offerings in the United States between 1978 and 2000).

99. *See* An Act Making Appropriations for the Expense of the State Government for the Fiscal Year Ending June 30, 2005, S.B. 320, 142nd Gen. Assem., at 4, 19 (Del. 2004), *available at* http://www.state.de.us/budget/budget/fy2005/fy2005-sb320-budget-bill.pdf (budgeting outlays of approximately $10.7 million for the Division of Corporations and $2.4 million for the Court of Chancery); STATE OF DEL., OFFICE OF THE GOVERNOR, POLICY AND FINANCIAL OVERVIEW: FISCAL YEAR 2005, at 12 (Jan. 29, 2004), http://www.state.de.us/budget/budget/fy2005/misc/FinancialOverview.pdf (forecasting a revenue of $523.2 million from franchise tax out of $2742.6 million in total revenue).

100. *See* Baudisch, *supra* note 5, at 51–52 (arguing that such a tax might violate Council Directive 69/335/EEC, raise constitutional concerns in many member states, and be resisted by business).

101. *See* World Bank, Key Development Data & Statistics, http://www.worldbank.org/data/countrydata/countrydata.html (last visited June 7, 2006).

trillion.[102] Even if a single member state assumed overnight a position similar to the one enjoyed by Delaware, its tax revenue from incorporations would probably be lower because it would command a smaller market. This revenue might be significant for some of the smallest member states. But, as will be explained below, these member states lack the necessary legal infrastructure to attract the sort of large public companies that can generate such revenue.[103]

The benefit to lawyers in providing services to incorporating companies is another force that is said to drive jurisdictions to compete for incorporations. However, the obvious interest of lawyers in incorporations does not mean that lawmakers will cooperate. Lawmakers will need a better reason to spend political capital before they will push any legislation that might encounter significant opposition.

Two factors explain the ease with which the Delaware corporate bar routinely pushes its proposals through the state legislative process. The first is the absence of any interest group in the state that might object to these proposals.[104] The second is the state's reliance on the fiscal gains from incorporations.[105] Delaware lawyers, to be sure, gain handsomely from their state's thriving incorporations business[106]—but so does the state. It reaps fiscal gains from incorporations that pay for a fifth of its public consumption at minimal political and economic costs, placing it second nationally in revenue per capita.[107] With this symbiotic relationship between lawyers, politicians, and the state, it is no wonder that corporate lawyers in Delaware get their way.

2. Competition for Investments

Capital investments fuel economic development both directly, by funding production activity, and indirectly, by deepening stock markets.[108] The latter, in

102. *See* World Federation of Exchanges, Domestic Market Capitalization, http://www.world-exchanges.org/WFE/home.asp?menu=315&document=2490 (last visited June 7, 2006) (reporting stock market capitalization of domestic companies by stock exchange).

103. *See infra* Part II.B.1.

104. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 59–60 (1993) (noting that Delaware has a diverse political constituency).

105. *See id.* at 60 (arguing that Delaware corporate law is minimally affected by an individual firm's lobbying because of the large number of Delaware incorporated companies and because most Delaware companies operate outside the state).

106. *See* Kahan & Kamar, *supra* note 1, at 694–98 (estimating that the additional income per Delaware lawyer from incorporations was roughly $35,000 per year in 2000).

107. *See* U.S. CENSUS BUREAU, STATE RANKINGS—STATISTICAL ABSTRACT OF THE UNITED STATES: STATE GOVERNMENT GENERAL REVENUE PER CAPITA 2003, http://www.census.gov/statab/ranks/rank24.html.

108. *See* Asli Demigrüç-Kunt & Vojislav Maksimovic, *Law, Finance, and Firm Growth*, 53 J. FIN. 2107, 2134 (1998) (finding that active stock markets are associated with externally financed firm growth); Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537, 537 (1998) (finding that stock market liquidity predicts growth, capital accumulation, and productivity improvements); P.L. Rousseau & P. Wachtel, *Equity Markets and Growth: Cross-Country Evidence on Timing and Outcomes, 1980–1995*, 24 J. BANKING & FIN. 1933, 1955 (2000) (finding that liquid stock markets promote economic growth). For the link between corporate law and stock markets, see Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1140–45 (1997)

turn, allocate funds to well-performing firms,[109] facilitate corporate restructuring through mergers,[110] and serve as outlets for selling startup companies.[111] This insight has not been lost on policymakers. Italian policymakers, for example, have acknowledged that "the growth of national industries does not depend only on their capacity for independent growth but also on the search for combinations with Italian or foreign partners, by means of mergers or stock swaps," and accordingly have endorsed "[l]egislation that facilitates such consolidation by reducing the reorganization costs that integration between different company structures inevitably entails."[112]

The sheer magnitude and visibility of these gains make them a much stronger political incentive than the gains from incorporations. After all, the difference between winning and losing in the competition for international capital is the difference between having billions of euros invested in local businesses and not having these funds. The mounting economic pressures on many member states in recent years, however, have raised the stakes of competition for investments, making it almost a political necessity.

One way these pressures have manifested themselves is in privatizations.[113] Privatizations motivate state officials to pay attention to corporate law for two reasons. First, during the privatization, quality law and liquid markets increase the revenue from selling shares of state-owned firms.[114] Second, after the

(finding that countries that protect shareholders have more valuable stock markets, larger numbers of listed securities per capita, and a higher ratio of initial public offerings than other countries).

109. *See* Jeffrey Wurgler, *Financial Markets and the Allocation of Capital*, 58 J. FIN. ECON. 187, 188–89 (2000) (finding that investor protection and developed stock markets improve capital allocation).

110. *See* Stefano Rossi & Paolo F. Volpin, *Cross-Country Determinants of Mergers and Acquisitions*, 74 J. FIN. ECON. 277 (2004) (finding that acquirers are based in countries with better corporate governance); Malcolm Baker, C. Fritz Foley & Jeffrey Wurgler, *Multinationals as Arbitrageurs? The Effect of Stock Market Valuations on Foreign Direct Investment* (Working Paper, Dec. 14, 2005), *available at* http://www.people.hbs.edu/ffoley/bakerfoleywurgler.pdf (finding that acquirers are based in countries with higher stock market valuations).

111. *See* Wendy Carlin & Colin Meyer, *How Do Financial Systems Affect Economic Performance?*, *in* CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 137, 156 (Xavier Vives ed., 2000) (finding that equity markets are associated with national economic growth through research and development).

112. *See* Draghi, *supra* note 25, at 356.

113. The privatization of Deutsche Telekom stock in 1997 illustrates the international dimension of privatizations driven by budgetary needs. *See* Greg Steinmetz & Michael R. Sesit, *Bigger Bang: Rising U.S. Investment in European Equities Galvanizes Old World*, WALL ST. J. Aug. 4, 1999, at A1 ("When Germany privatized Deutsche Telekom AG two years ago in one of the largest initial public offerings in history, it marketed the stock to American investors, as well as Europeans. It did the same earlier this year when it carried out a secondary offering. By plugging the stock to Americans, it increased demand and so boosted the value of Telekom shares. Deutsche Telekom is now worth three times what it was two years ago. And when Berlin begins selling the rest of its stake, the proceeds will give a much-needed boost to the government's finances.").

114. A telling example is the success that American mutual fund Fidelity had in 1997 dissuading the French government from using its control over mining company Eramet to placate New Caledonian separatists by swapping one of the company's mines for an inferior one controlled by the separatists. It helped that the skirmish took place less than three months before a $7 billion initial public offering of

privatization, maintaining the value of privatized firms is vital to the public trust in the government and the politicians associated with the privatization.

In fact, a major corporate scandal can shake up the government even if it involves a company that was never state-owned. This too has been a common occurrence in recent years, as can be expected during an economic downswing. To be sure, scandals can precipitate reform independently of competition for investments. But they carry with them an added penalty for countries that depend on mobile capital.[115] The knowledge that a scandal involving a single domestic company can taint the entire economy creates a strong incentive for lawmakers.[116] If they have any doubt about their responsibility, the financial press will quickly erase it, as the following article published after the collapse of dairy producer Parmalat in 2003 illustrates:

> Now, in Parmalat, an Italian food and milk-products company, Europe has a corporate scandal of truly Enronesque proportions. If the integrity of European business is to be restored, and public confidence in the continent's capital markets is to be sustained, Europe's response will have to be as determined and sweeping as America's . . . .
>
> It has been tempting for international investors to think of Europe as a single investment space. The reality is that harmonisation of Europe's industrial and financial markets still has a long way to go. Local practices matter, never more so than when things go wrong . . . .
>
> The danger to honest Italian business could not be clearer: their cost of capital will rise if investors begin to discriminate against a country that had been trying to shake off a reputation for dark dealings. In fact, this is precisely what international investors should now do. The sheer scale of the Parmalat scandal raises serious questions about Italian business practices which only a thorough, and very un-Italian, clean-up can now dispel.[117]

France Telecom. All Fidelity had to do was to remind the French government that American investors would shun French privatizations if it did not back down. *See id.*

115. *See* Richard Evans, *Applying Pressure: European Funds Increasing Corporate Activism*, PENSIONS & INVESTMENTS, Feb. 23, 2004, at 14 (reporting growing activism by British pension fund manager Hermes, Dutch pension fund managers ABP and PGGM, and French pension fund manager Caisse des Dépôts at Consignations following a string of corporate governance scandals); *see also* Craig Karmin & James Hookway, *Calpers to Reverse Position on Investing in Philippine Market*, WALL ST. J., May 13, 2002, at C1 (reporting a widespread belief among stock market participants that the decision by CalPERS to liquidate its stock investments in the Philippines in 2002 had a more negative impact on the Manila stock exchange because it came at the heels of a stock manipulation scandal one year earlier).

116. *See, e.g.*, Nicholas George, *Sweden in Business Law Move*, FIN. TIMES (London), Jan. 19, 2004, at 24 (reporting that the Swedish Minister for financial markets expressed disappointment with the failure of business leaders to take effective measures to restore the confidence in Swedish business, which "has been rocked by several corporate scandals, the most high-profile domestic example involving huge bonus payments and management perks at Skandia, the financial services group" and expressed resolve to address the crisis in legislation if this failure continued).

117. *Turning Sour*, THE ECONOMIST, Jan. 3, 2004, at 8; *see also* Richard Heller, *Parmalat: A Particularly Italian Scandal*, FORBES.COM, Dec. 30, 2003, http://www.forbes.com/2003/12/30/cz_rh_1230parmalat_print.html ("Parmalat is reminiscent of several other florid Italian scandals,

The link between legislation triggered by corporate scandals and competition for investments is evident when the scandals involve foreign companies. Unlike legislation triggered by local corporate scandals, which can be explained both as a response to a public outcry and as an effort to shore up investor confidence in local companies, legislation triggered by foreign corporate scandals can only be explained by the latter. Foreign scandals have played a significant role in catalyzing reform in a number of European member states—sometimes even more than local events. One such scandal was the 2001 collapse of giant American corporation Enron amid accounting irregularities. The Enron scandal was followed closely in the European Union. In the United Kingdom, for example, it prompted the government to accelerate and expand a preexisting plan for corporate reform, labeling its actions "post-Enron initiatives."[118] In Italy, it fueled calls for accounting reform.[119] Enron did not anger British or Italian voters; rather, it was a focusing event that reminded British and Italian lawmakers that their countries too could be hit by a similar scandal and lose their appeal to investors.[120] In the case of Italy, this fear took only two years to become a reality.

Last, capital investments strengthen the local financial industry which—in addition to being a driver of the national economy[121]—can be influential. The keen interest in helping the local financial industry compete internationally is a recurring motif in the legislative agenda of more than one member state. It has played a role, for instance, in Italy, where reformers emphasized, under the heading "The Prospects of the Italian and European Stock Exchanges":

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especially the Banco Ambrosiano affair .... The Parmalat story simply does not fit into a global corporate-governance argument. It's beyond the pale; it's very Italian.").

118. *See* DEP'T OF TRADE & INDUS., CORPORATE LAW AND GOVERNANCE: POST ENRON INITIATIVES (U.K.), http://www.consumer.gov.uk/cld/post_enron.htm (last visited June 7, 2006); *see also* Paul Davies, *Post-Enron Developments in the United Kingdom*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 185 (Guido Ferrarini, et al. eds., 2004) (documenting the legislative response in the United Kingdom to Enron).

119. *See* Robert Galbraith, *Disappointment and Dissatisfaction in Italy*, THE ACCOUNTANT, Sept. 25, 2002, at 16 (reporting that stories of accounting scandals in the United States are fueling calls for accounting reforms in Italy).

120. *See* THOMAS A. BIRKLAND, AN INTRODUCTION TO THE POLICY PROCESS 116 (2001) ("Focusing events can lead groups, government leaders, policy entrepreneurs, the news media, or members of the public to pay attention to new problems or pay greater attention to existing but dormant (in terms of their standing on the agenda) problems, and, potentially, can lead to a search for solutions in the wake of perceived policy failure."); *see also* JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 94 (2d ed. 1995).

121. *See* Thorsten Beck, Ross Levine & Norman Loayza, *Finance and the Sources of Growth*, 58 J. FIN. ECON. 261, 265 (2000) (finding that financial intermediaries increase factor productivity and gross domestic product growth); Klaus Neusser & Maurice Kugler, *Manufacturing Growth and Financial Development: Evidence from OECD Countries*, 80 REV. ECON. & STAT. 638, 645 (1998) (finding that financial intermediaries increase factor productivity); Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559, 584 (1998) (finding that industrial sectors in need of external financing develop faster in countries with more developed financial markets).

> The future of the European financial industry will see savings channeled towards the financial centres where they are most efficiently managed. Those centers will unfailingly become the places of greatest concentration of financial structures and infrastructure. An intensive planning effort will be necessary to avert the marginalization of the Italian financial industry and prevent it from being reduced merely to managing local monopoly positions.[122]

Building a strong financial center has also been an important legislative goal in Germany, where in 1992 the government branded its legislative campaign "Financial Center Germany" ("*Finanzplatz Deutschland*").[123] Accordingly, the proposal for a recently adopted corporate reform stated that its objective was to "strengthen Germany's ability to compete as a financial centre and enhance the function of the capital market as a force promoting growth and employment."[124]

The same has held true for France[125] and the United Kingdom. In the latter, a 1995 government white paper titled "Competitiveness" concluded that, while London was still "the leading international financial centre in Europe," it would "continue to face competitive pressures from elsewhere," noting "initiatives to promote the attractions of established rival centres, such as Europlace for Paris and Finanzplatz Deutschland for Frankfurt."[126]

The market for investments is different from the market for incorporations not only in its higher stakes but also in its ability to sustain participation by multiple jurisdictions. There are two related reasons for this. The first is the difference in stakes. Delaware, the leading state of incorporation in the United States, currently earns about $500 million a year by taxing incorporations. If Delaware were to split this amount with an equal rival, each would collect no more than half. This is not a lot of revenue for a state, and certainly not a lot for a country. By contrast, the stock capitalization of public companies alone in the European Union was $8 trillion in 2003. A conservative estimate of the foreign investments in these companies in that year exceeds $2 trillion.[127] Splitting this amount and the economic development it can generate between several jurisdic-

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122. Draghi, *supra* note 25, at 345.

123. *See* Deeg, *supra* note 32, at 180.

124. *See* FED. MINISTRY OF FIN., DRAFT OF A FOURTH FINANCIAL MARKET PROMOTION ACT (trans., Nov. 14, 2001) (F.R.G.), http://www.bundesfinanzministerium.de/nn_13044/EN/10420.html. The proposal further explains that to achieve this objective the government intends "to improve investor protection by enhancing market integrity and transparency, to afford market participants extended and more flexible scope for action, and to close gaps in the defences against money laundering." *Id.*

125. *See generally* Colin Gordon, *The Business Culture in France*, *in* BUSINESS CULTURES IN EUROPE 86 (Collin Randlesome et al. eds., 1990).

126. *See* DEP'T OF THE ENV'T, TRANSP. & THE REGIONS, COMPETITIVENESS: FORGING AHEAD 1995, Cm. 2867, at 3.3, *available at* http://www.archive.official-documents.co.uk/document/dti/dti-comp/tchap3.htm#t3-25.

127. In the years 2000 and 2001, foreign institutional investors held between 30% and 40% of publicly traded stock in the United Kingdom, Spain, Norway, France, Sweden, and Poland; between 20% and 30% in Germany, Greece, Portugal, and Denmark; 15% in Italy; and 5% in Estonia. *See* Share Ownership Survey, *supra* note 19, at 40.

tions still leaves enough worth fighting for.

Secondly, unlike the market for incorporations, the market for investments is not one in which the winner takes all. Delaware dominates the market for incorporations in the United States. It is the legal domicile of half of the public companies and virtually all of the companies that incorporate outside their home state when they go public. But it carries this burden in stride. Indeed, judging from the modest outlays for its chartering business,[128] and its efforts to attract more business to its division of corporations and chancery court,[129] Delaware would charter all public companies in the United States if only given the chance. The market for capital is different because it channels investments into physical businesses. There is a limit to the amount of capital that investor-friendly legislation can attract to a jurisdiction because, as production increases, so too does the cost of local labor and other means of production that are less mobile than capital.[130] This limit gives hope to other jurisdictions that, with proper legislation, they can also attract capital.[131]

B. COSTS

Competing for incorporations is costly. It differs from competition in the private sector only in that it involves political costs in addition to economic ones.[132] The costs that stand out in the European Union are building legal infrastructure and overcoming resistance from interest groups. The former cost inhibits competition by small member states. The latter cost inhibits competition by large ones. The combination of the two leaves precious little ground for

128. *See supra* note 99 and accompanying text (stating that the 2005 budget forecasted outlays of $15 million).

129. *See, e.g.*, Leo E. Strine, Jr., *"Mediation-Only" Filings in the Delaware Court of Chancery: Can New Value Be Added by One of America's Business Courts?*, 53 DUKE L.J. 585, 586 (2003) (noting that the chancery court can provide value to its business citizens through judge-conducted mediation).

130. *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419–20 (1956) (describing a model in which communities attract individuals by offering services until they reach an optimal community size). Previous analyses of corporate lawmaking in federal systems, including my own, have analogized the competition for incorporations to the Tiebout model. *See, e.g.*, John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 453 n.27 (1995); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 691 n.29 (1984); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1948 n.156 (1998); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 466 n.21 (1988). Competition for investments, however, is closer to the Tiebout model because, in both, jurisdictions face increasing costs of providing services as the number of users grows. While in theory jurisdictions should also face increasing costs of providing incorporation services, in practice these costs are small.

131. In 2002, when Indonesia, Malaysia, the Philippines, and Thailand went out of favor as worthy places for investment, CalPERS decided to reallocate some of its investments in the four Southeast Asian countries to Hungary and Poland. *See* Craig Karmin & Kara Scannell, *Calpers's Withdrawal Hits Markets in Asia, But Fallout May Be Brief*, WALL ST. J., Feb. 25, 2002, at C12. CalPERS presumably did not reallocate the freed-up funds to jurisdictions with stronger records of investor protection because the quality of investor protection was only one of its investment criteria.

132. *See* Kahan & Kamar, *supra* note 1, at 730–35.

competition to develop. While these costs do not disappear in competition for investments, they can be offset by the higher stakes involved, which can induce even large jurisdictions with developed legal infrastructure to compete, and can mollify even strong interest groups by forcing them to internalize the cost of their resistance.

1. Competition for Incorporations

Impressed by tiny Delaware's successful pursuit of incorporations, some commentators have suggested that the smallest member states in the European Union might compete for incorporations on the theory that they alone would value the modest gains to be had.[133] But these member states lack the necessary legal infrastructure to attract incorporations. Consider, for example, Estonia, Latvia, and Malta, the member states with the smallest budgets in the European Union and with total government revenues in 2004 of less than €4 billion each.[134] It is true that these member states might be interested in incorporations, but their interest is not enough.[135] Corporate laws in Estonia and Latvia are antiquated versions of German or French corporate law that have been in hibernation for several decades and only recently received a facelift to meet the minimum requirements of the European Union.[136] And all three member states rank low in the European Union in government effectiveness and control of corruption.[137] It is hard to believe that they would attract the sort of large puhlic

133. *See* Dammann, *supra* note 5, at 528–30 (listing Estonia, Hungary, Cyprus, the Czecb Republic, Latvia, Lithuania, Malta, Poland, and Slovakia as potential competitors).

134. *See* IVANA JABLONSKA, GENERAL GOVERNMENT EXPENDITURE AND REVENUE IN THE EU IN 2004, at 2 tbl.1 (May 30, 2005), http://epp.eurostat.cec.eu.int/cache/ITY_OFFPUB/KS-NJ-05-024/EN/KS-NJ-05-024-EN.PDF.

135. While corporate law is not their strongest point, all of the new member states have historically offered foreign businesses an array of tax incentives regarded by the European Commission as harmful. *See* Daniel Dombey, *New EU Entrants Fail to Cut Tax Breaks*, FIN. TIMES (London), Jul. 22, 2003, at 6. Malta, for example, is better known for its advantageous taxation of offshore holding companies than for its corporate law. *See Good Havens*, THE ECONOMIST, Sept. 30, 1995, at 90 (noting tax exemptions for offshore holding companies); Godfrey Grima, *Malta Aspires to Become a Leading Financial Centre*, FIN. TIMES (London), Dec. 9, 2003, at 3 (noting displeasure of the European Commission with the taxation of offshore holding companies in Malta).

136. *See* Marie-Agnes Arlt et al., *The Status of the Law on Stock Companies in Central and Eastern-Europe: Facing the Challenge to Enter the European Union and Implement European Company Law*, 4 EUR. BUS. ORG. L. REV. 245, 247 (2003) (describing the corporate laws of Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia, and stating that "[m]ost Central and Eastern European company law can be traced back to the German . . . or French legal tradition").

137. *See* World Bank Institute, Aggregate Governance Indicators 1996–2004, http://www.worldbank.org/wbi/governance/pdf/2004kkzcharts.xls (last visited June 7, 2006) (ranking these member states in the bottom half of the European Union on government effectiveness and control of corruption, and ranking Slovenia and Latvia in the bottom half of the European Union for rule of law in 2004); *see also* Transparency International, Corruption Perceptions Index 2005, http://www.transparency.org/policy_research/surveys_indices/cpi/2005 (last visited June 7, 2006) (ranking these member states in the bottom half of the European Union in perceived corruption).

companies that generate the bulk of Delaware's profits.[138]

Recognizing the disadvantages of these member states, some commentators look to Luxembourg, the smallest developed member state in the European Union, to carry the torch of competition.[139] Perhaps. But Luxembourg is not that small. In 2003, its revenue totaled €6.35 billion[140]—three times higher than Delaware's.[141] Accordingly, it has done nothing to signal an intention to compete for incorporations. It did not rush to amend its law to allow foreign companies to incorporate in it, nor did it respond to the call for comments on a proposed European Union directive that would enable companies to reincorporate.[142] Although Luxembourg may begin to show interest in incorporations as the ability to incorporate abroad becomes established, there are reasons to doubt that it will.[143] The backbone of Luxembourg's economy is financial services. Corporate law, by contrast, is not the country's strong point. In fact, along with other corporate laws in the French tradition, Luxembourg corporate law receives the lowest marks in international comparisons.[144] Few lawyers outside Luxembourg are familiar with this law, and many would find the fact that

138. *Cf.* Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1251 tbl.3 (2001) (reporting that about 1600 large public companies out of more than 200,000 Delaware companies generated more than half of the state's franchise tax revenue in 1997–1999).

139. *See* Dammann, *supra* note 5, at 528–30 (mentioning Luxembourg, along with Ireland, Portugal, and Greece, as potential candidates); Hertig & McCahery, *supra* note 5, at 187 (mentioning Luxembourg and Ireland as potential candidates).

140. *See* Service Central de la Statistique et des Études Économiques, Luxembourg in Figures 37 (2004) (Lux.), http://www.statec.lu/html_fr/publications/luxenchiffres2004EN.pdf.

141. *See* STATE OF DEL., OFFICE OF THE GOVERNOR, FINANCIAL SUMMARY: FISCAL YEAR 2005, at 2 (2004), http://www.state.de.us/budget/budget/fy2005/operating/05opfinsumcharts.pdf (noting a revenue of $2.4 billion in 2003). The exchange rate in 2003 ranged between 0.94 and 0.81 euro for one U.S. dollar. Some commentators argue that the relevant figure for a state's incentive to compete for incorporations is gross domestic product because it reflects the extent of economic activity that could be taxed should the need arise, and note that Luxembourg's gross domestic product is one-half of Delaware's. *See* Dammann, *supra* note 5, at 528. As a practical matter, however, public officials tend to consider existing budgetary sources and needs, rather than hypothetical ones.

142. Of 127 responses to the call by the European Commission in 2004 for comments on the proposal, 52 responses came from Germany; 21 from France; 9 from the Netherlands; 7 from Belgium; 6 from Spain; 5 from the United Kingdom; 4 from Finland and Portugal; 3 from Austria, Greece, and Italy; 2 from the Czech Republic and Estonia; 2 from undisclosed countries; and 1 from Denmark, Ireland, and Sweden. No responses came from Luxembourg, Cyprus, Hungary, Lithuania, Latvia, Malta, Poland, Slovakia, or Slovenia. *See* Public Consultation on the Outline of the Planned Proposal for a European Parliament and Council Directive on the Cross Border Transfer of the Registered Office of a Company, http://europa.eu.int/yourvoice/results/transfer/index_en.htm (last visited June 7, 2006).

143. Note that a market in which only one state attempts to attract incorporations is quite different from a market in which many states compete. *See* Kahan & Kamar, *supra* note 1, at 736–47 (comparing a market with a single competing state among many inactive ones with a market in which several states compete).

144. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1139 (1998) (noting that "French-civil-law countries protect [investors] the least").

English is not an official language in Luxembourg to be a deterrent.[145]

Another cost of competing for incorporations is overcoming political opposition. Lawmakers will not spend political capital to attract incorporations just because doing so might benefit the state. They will first consider the effects of such an effort on their careers, taking into account the magnitude of the benefits to the state, the time and likelihood involved in achieving results, the ability to claim credit for success, the repercussions of failing, the availability of alternative legislative projects, and the likely opposition.[146]

In the European Union, opposition can be substantial because an intricate web of interest group politics shapes corporate law in many member states, especially the ones with the necessary legal infrastructure for attracting incorporations. One such political hurdle is strong labor. If there is one matter on which managers and shareholders agree, it is limiting employee influence over corporate strategy. Yet this is also among the most sensitive political issues in developed member states.[147] A related hurdle is protectionism. Efficient corporate law allocates corporate assets to their best use. However, it requires neutrality that politicians tend to lack when it means the transfer of local businesses to foreign hands.[148]

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145. *See The Galling Rise of English*, THE ECONOMIST, Mar. 1, 2003, at 42 (noting that English has become the language of business in the European Union). It is irrelevant that many Luxembourgians speak English because this language is not used in courts.

146. *See* Kahan & Kamar, *supra* note 1, at 727–35; *cf.* R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION 68–71 (1990) (describing the difficulty of mobilizing an inattentive electorate).

147. *See* Marco Pagano & Paolo Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005, 1027 (2005) (finding that employee protection tends to be stronger, and shareholder protection tends to be weaker, proportionally, as opposed to majoritarian, electoral systems); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 541 (2000) (arguing and presenting evidence that social democracies tend to have weaker shareholder protection).

148. *See, e.g.*, *Banco Bilbao Vizcaya Argentaria: Italian Bank Endorses Offer, Moving Closer to a Final Deal*, WALL ST. J., Apr. 11, 2005, at 1 (noting that the Bank of Italy "stymied previous attempts at foreign takeovers"); Paul Betts & Victor Mallet, *A French Solution*, FIN. TIMES (London), July 3, 2002, at 18 (describing the political opposition that blocked the acquisition of French oil company Elf Aquitaine by Italian group Eni in 1999 and the acquisition of Belgian company Société Générale de Belgique by Italian financier Carlo De Benedetti in 1988); Andrew Bulkeley & Ross Tieman, *Fighting the Inevitable in France*, CORP. CONTROL ALERT, June 2004, at 20 (describing the intervention by the French government to stir French pharmaceutical maker Aventis away from Swiss acquirer Novartis and into the hands of its domestic rival Sanofi-Synthelabo in 2004); Daniel Dombey & Hugh Williamson, *Germany Tells Brussels It Will Not Alter VW Law*, FIN. TIMES (London), July 13, 2004, at 11 (describing a showdown between Germany and the European Commission over a law to protect carmaker Volkswagen from foreign acquisitions); Patrick Jenkins, *Ackermann's Agenda: Deutsche Bank Grapples With Divisions Over Strategy*, FIN. TIMES (London), Sept. 16, 2004, at 19 (describing the lobbying by German powerhouses Siemens, Deutsche Telekom, and SAP to prevent foreigners from buying Deutsche Bank); Carlta Vitzthum, *Madrid Exercises Its 'Golden Shares' on Foreign Deals*, WALL ST. J., May 18, 2000, at A23 (describing the government blocking of an acquisition of the Spanish company Telefonica by Dutch company KPN, an acquisition of the Spanish company Hidroelectrica del Cantabrico by Electricité de France, and an acquisition of Telecom Italia by Deutsche Telekom).

2. Competition for Investments

It is hard to compare the costs of harnessing corporate law to attract investments to the costs of harnessing corporate law to attract incorporations. Some of the costs are higher in the case of the former type of competition; other costs are higher in the latter; and still other costs are the same. This Section, therefore, does not argue that competition for investments will always be present where competition for incorporations is not—only that it can be. In the European Union, this is already the case.

Consider first the cost of building legal infrastructure. This cost is the same whether member states compete for investments or for incorporations. In either case, only member states that provide quality legislation, adjudication, and legal services can compete. But in the case of competition for investments, the large and developed member states possessing such legal infrastructure are motivated to compete. These member states may well have been the most active in the wave of corporate law reforms of recent years.

Consider next the cost of overcoming opposition. Because competition for investments mainly affects local businesses, it will normally encounter stronger opposition from local corporate constituencies than competition for incorporations. But this opposition can be muted if competitive pressures in the markets for products, capital, and labor compel these constituencies to internalize the cost of inefficient corporate law and to accept reform.

Witness the recent push in Germany to relax the so-called codetermination rights entitling employee representatives to half of the supervisory board seats in large companies.[149] Such a reform was unthinkable only a decade ago. Today, it is endorsed by employer organizations, large banks, and state officials as essential to prevent business from fleeing Germany in an increasingly integrated and competitive economic environment.[150] Thus, a 2004 report by the two

149. *See* Gail Edmondson, *Cut Labor's Clout on German Boards; The "Co-determination" System is Hobbling the Nation's Economy*, BUS. WK., Nov. 15, 2004, at 84 (noting that relaxing the decades old codetermination rules "could be a secret bullet against outsourcing and high unemployment"); David Gow, *Chill Enters Cosy German Boardrooms; Industry Chiefs Want to Consign to History British-Inspired Era of Co-Determination*, THE GUARDIAN (London), Oct. 25, 2004, at 22 (noting the President of Kiel's Institute for the World Economy opining that Germany's codetermination "must be adapted to meet modern demands for entrepreneurial flexibility, especially among foreign investors" and adding that "[t]he most telling business argument for change is that co-determination is an obstacle to cross-border mergers or, as in the case of Hoechst and Rhone-Poulenc (now Aventis), forces the transfer of the company headquarters outside Germany"); Matthew Karnitschnig, *German Board Law Targeted; Industry Seeks to Cut Seats of Workers to Reduce Unions' Power*, WALL. ST. J., Oct. 28, 2004, at A13 (reporting a "declaration of war" by the German Industry Association and the German Employers Association on a "pillar of the German workers' movement that has defined labor relations for a generation"—the rights of employees to half of the seats on supervisory boards of big corporations—"as companies increasingly shift factories and jobs from Germany to cheaper, less regulated markets").

150. *Workers Cut Back: Germany's Codetermination Law Must Adapt to New Times*, FIN. TIMES (London), Nov. 1, 2004, at 18 (noting that "global competition and European integration are finally putting pressure on . . . the 28-year-old law that gives employees equal representation on the supervisory boards of large companies").

largest employer organizations in Germany complains that codetermination inhibits the growth of German companies by making them unattractive merger partners abroad.[151] Similarly, according to the chair of the German government's standing committee on corporate governance, who also chairs the supervisory board of ThyssenKrupp, the country's fifth largest industrial company, "[o]ther countries do not regard German codetermination practices in their current form as a plus point for Germany as a business location."[152] Reforming codetermination would no doubt adversely affect German employees. But losing jobs to employees abroad would be worse.[153]

III. NORMATIVE IMPLICATIONS

Standard accounts of corporate lawmaking in federal systems explain the rate at which jurisdictions innovate and the degree to which they accommodate corporate decisionmakers as a product of competition for incorporations.[154] This does not mean, however, that the law must stagnate when this type of competition is absent. Competition for investments has powerful and quite different effects of its own. It affects companies based on their location rather than their legal domicile, and can spread over many jurisdictions, including large ones, without any jurisdiction dominating the market. This explains how corporate reforms have been spreading in the European Union in the absence of freedom to incorporate abroad and, as will be explained below, why introducing this freedom may even undermine the trend. The choice to incorporate abroad may therefore be a mixed blessing. On the one hand, it frees firms from having

151. For the claim by Germany's largest employer organizations that labor representation on the board deters foreign investors and makes German companies unattractive merger partners, see BUNDESVEREINIGUNG DER DEUTSCHEN ARBEITGEBERVERBÄNDE & BUNDESVERBAND DER DEUTSCHEN INDUSTRIE, MITBESTIMMUNG MODERNISIEREN [Union of the German Employers' Associations & Association of the German Industry, Modernizing Codetermination] 7–8, 19 (2004) (F.R.G.), http://www.bdi-online.de/dokumente/berichtbdabdikommissionmodernisierungmitbestimmung.pdf. For a similar claim by a leading German commentator, see Marcus Lutter, *Perspektiven des Gesellschaftsrechts in Deutschland und Europa [Perspectives on Corporate Laws in Germany and Europe]*, 59 BETRIEBS-BERATER I (2004) (F.R.G.).

152. Gerhard Cromme, Status and Development of Corporate Governance in Germany, Address at the 3rd German Corporate Governance Code Conference 17 (June 24, 2004), http://www.corporate-governance-code.de/eng/download/CGC_Conference_Berlin_2004_Dr_Cromme.pdf.

153. The danger of job loss was illustrated vividly in the threats made by the large German microprocessor maker Infineon to relocate into Switzerland to cut taxes and labor costs associated with Germany's codetermination. *See A Warning Shot*, WALL ST. J. EUR., Apr. 30, 2003, at A8; Matthew Karnitschnig, *Infineon May Shift Base from Germany*, WALL ST. J. EUR., Apr. 29, 2003, at A1. The pressure on German labor unions to accept a cutback on their codetermination rights is part of a general pressure on them and on labor unions in other member states to share the burden of economic recovery under threats of layoffs. *See* Matthew Karnitschnig & Marcus Walker, *Firms in Germany Pressure Unions to Accept Change*, WALL ST. J., Dec. 21, 2004, at A14.

154. The definitive work in this area is Romano, *supra* note 2. For updated empirical findings, see Roberta Romano, *The States as a Laboratory: State Competition for Corporate Charters*, *in* PROMOTING THE GENERAL WELFARE: AMERICAN DEMOCRACY AND THE POLITICAL ECONOMY OF GOVERNMENT PERFORMANCE (Alan S. Gerber & Eric M. Patashnik eds., forthcoming 2006); *see also* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 760–77 (1998).

to wait for their home jurisdiction to bring the quality of local corporate law up to the level available elsewhere. On the other hand, to the extent that this freedom eases the pressure on jurisdictions with inferior corporate law to improve, it deprives firms locked in them of the improvements that more intense competition for investments would produce. In the European Union today, the balance of the two effects is likely to be positive.

A. COMPETITION FOR INVESTMENTS AND COMPETITION FOR INCORPORATIONS COMPARED

In order to understand how the introduction of a freedom to incorporate abroad will affect corporate lawmaking in the European Union, it is helpful to first compare current regulatory dynamics in which this freedom is missing and member states compete only for investments, to a world in which this freedom exists and member states compete only for incorporations. This comparison is not meant to suggest that the introduction of the freedom to incorporate abroad will replace the existing competition for investments with competition for incorporations. It probably will not. Rather, the comparison here situates the current regulatory dynamics of the European Union against those postulated in traditional analyses of corporate lawmaking in federal systems, and marks the two as extreme points along a continuum of possible regulatory dynamics that later Sections will explore.

1. Who Competes and How

Perhaps the most apparent distinction between competition for investments and competition for incorporations is in the type and the number of jurisdictions likely to compete. Competition for incorporations naturally involves only a handful of small jurisdictions, or a single small jurisdiction, because the benefits from attracting incorporations are modest and because firms gravitate toward the jurisdiction with the largest number of incorporations. In the United States, that jurisdiction is Delaware—a state that ranks forty-fifth in population and thirty-eighth in gross product.[155] A similar pattern in the European Union would mean a clustering of incorporations in a single small member state and a lack of attention by larger member states to incorporations.

Competition for investments is different. The higher stakes involved, and the inability of firms to cluster in a single jurisdiction, enable any number of jurisdictions of any size to compete. These are the dynamics of corporate lawmaking in the European Union today, where competition for investments has been fueling corporate law reforms even—and perhaps especially—in the larg-

155. *See* U.S. CENSUS BUREAU, STATE RANKINGS—STATISTICAL ABSTRACT OF THE UNITED STATES: RESIDENT POPULATION—JULY 2005, http://www.census.gov/statab/ranks/rank01.html (last visited June 7, 2006); U.S. CENSUS BUREAU, STATE RANKINGS—STATISTICAL ABSTRACT OF THE UNITED STATES: GROSS STATE PRODUCT IN CURRENT DOLLARS 2004, http://www.census.gov/statab/ranks/rank28.html (last visited June 7, 2006).

est and most developed member states. It is beyond the scope of this Article to test whether large and developed jurisdictions use corporate law to compete for investments more than other jurisdictions. Such a finding would certainly be consistent with the major corporate law reforms in such member states as Germany, Italy, and France in recent years. It could be explained by the pressure for reform that a developed industry can apply to lawmakers as well as by the likelihood that a developed jurisdiction will possess the necessary legal infrastructure to compete.[156] But it is not necessary to resolve this question here. Regardless of whether large and developed jurisdictions use corporate law to compete for investments more than other jurisdictions, they certainly do not appear to fall behind.

While competition for investments and competition for incorporations attract different sets of jurisdictions, the incentives they create are similar. In both cases, competing jurisdictions produce the law most likely to win the approval of both managers who must initiate corporate decisions, and shareholders who must consent to them. In the European Union, competition for investments has thus far resulted in a trend toward shareholder protection, a reassuring sign for the view that regulatory competition results in a race to the top.[157] Thus, between 1993 and 2002 alone—before several important reforms took place—a widely-used country score for shareholder protection either increased or remained unchanged in each of fourteen European member states surveyed in a study of corporate laws around the world.[158]

More specifically, however, the trend has been toward adopting rules and practices similar to those in the United Kingdom and the United States. The use of Anglo-American corporate law as a reference point is noteworthy. While there are many ways to appease shareholders, the Anglo-American way is particularly effective because it is British and American institutional investors who have spread shareholder activism globally,[159] and with the advent of

156. Other factors that may affect the propensity to compete for investments through corporate reform include budget deficit, privatizations, industry exposure to foreign competition, and demand by local industry for additional capital.

157. *See* Pagano & Volpin, *supra* note 147 (finding that over the 1990s shareholder protection improved on average in forty-five countries despite the absence of changes in electoral systems or legal origin, and concluding that in that decade there was international convergence in shareholder protection); *UK Governance Is the Best in Europe*, ACCOUNTANCY, Mar. 1, 2004, at 113 (citing a report by Brussels research firm Deminor that concludes that corporate governance standards are improving in Continental Europe as a whole).

158. The shareholder protection score is the so-called "antidirector rights" indicator constructed in La Porta et al., *supra* note 144, at 1134. It is tracked for every year from 1993 to 2002 in Table A3 of the Data Appendix to Pagano & Volpin, *supra* note 147, *available at* http://www.dise.unisa.it/CSEF/people/pagano/pv_aer_data_appendix.pdf. The increase was the highest for Italy, which received a score of 1 in 1990 and 5 in 2002, consistent with the fact that Italian government officials had publicly cited that score as a benchmark for Italy's corporate reform. *See* Ulissi, *supra* note 68, at 2.

159. *See* Simon Targett, *Custodians Are Casting Votes as They Take On a More Active Role*, FIN. TIMES (London), July 6, 2001, at 8 (noting that investors are becoming increasingly active in corporate governance). Continental European investors have gradually adopted Anglo-American shareholder activism and expectations themselves. *See* Sara Calian, *Making Union Investment's List Isn't Pleasing*

international law firms, investment banks, and accounting firms, the legal template they endorse has become the gold standard in shareholder protection worldwide.[160]

2. Firms That Benefit from Competition for Incorporations

Thus far we have identified two key differences between the existing competition for investments and the potential competition for incorporations among member states of the European Union. First, the competition for investments involves large industrialized jurisdictions across the continent rather than a single jurisdiction or a few small jurisdictions. Second, the beneficiaries of this competition are local corporations in competing jurisdictions rather than foreign corporations that incorporate in these jurisdictions. It is now a simple matter to describe the effects of the two types of competition on social welfare, defined as aggregate utility.

The beneficiaries of competition for incorporations are likely to be firms that are currently located in member states that do not offer the best corporate law in the European Union and that given the choice would incorporate abroad. Italian firms, for example, may well benefit from the efforts of Italian lawmakers to improve local corporate law. But these efforts do not mean that Italian corporate law is the best in the European Union today or, more importantly, the best that would be found in the European Union if member states competed for incorporations. From the perspective of Italian firms that would incorporate abroad, competition for incorporations would be preferable to the current competition for investments because it would grant them access to the leading corporate law in the European Union.

These Italian firms would also reap the benefits of higher economies of scale in the production and the consumption of corporate law than available to them today. The current inability of companies in the European Union to incorporate abroad creates balkanization. It is impractical for all, or even most, firms to operate in one member state. They must spread geographically and be governed by different legal regimes. While these regimes may over time come to resemble each other, they do not offer the full benefits that a single regime

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to European Firms, WALL ST. J., Feb. 15, 2002, at C10 (reporting the German pension fund Union's use of public shaming to pressure underperforming companies); Evans, *supra* note 115 (reporting shareholder activism to improve voting rights and broader governance by ABP and PGGM in the Netherlands, Caisse des Dépôts et Consignations in France, and DWS, Union, and SEB in Germany); Paula Garrido, *Shareholders Want Their Voices Heard*, FIN. TIMES MANDATE (London), Mar. 8, 2004 (describing the European Corporate Governance Service, an umbrella organization that comprises eight regional corporate governance organizations representing France, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the Nordic Region); Sylvia Pfeifer, *Shell Investors Demand Royal Dutch Meeting*, SUNDAY TELEGRAPH (London), Mar. 28, 2004, at 2 (reporting that institutional investors from the United States, the United Kingdom, and Germany requested a meeting with the chairman of Royal Dutch to discuss accounting irregularities).

160. *Cf.* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 841–47 (1995) (arguing that Delaware's dominance in attracting corporations persists in part because of the presence of network externalities arising from legal precedents and services).

governing all firms would offer in administrative and judicial expertise, access to legal services, comprehensive case law, and comparability among firms. All of these benefits would be available to European firms if they incorporated in a single jurisdiction, as many American firms do.

3. Firms That Benefit from Competition for Investments

Not all firms would rush to incorporate abroad even if they were free to do so. Most private companies, and many public companies, would consider the cost of incorporating abroad to be too high, especially if it entails changing lawyers. In the United States—where there are no language or culture barriers to incorporating in Delaware while conducting business in another state and where legal advice on Delaware law is readily available nationwide—the vast majority of private companies incorporate in their home state. In 1999, for example, Delaware was the legal domicile of only 230,000 companies out of roughly five million companies in the country.[161] Even public companies do not necessarily incorporate in Delaware. Only half of them (typically the larger ones) do so.[162] Many companies in the European Union would be in a similar position.

Companies whose employees, creditors, or managers would oppose a move would also find incorporation abroad costly.[163] Shareholders and managers would probably support incorporation in a member state with minimal employee or creditor protection.[164] But while their agreement would be enough for incorporating new companies, existing companies would need to negotiate with employees and creditors with vested rights.[165] Moreover, managers themselves could be reluctant to reincorporate if they believed that the foreign law overly

161. *Compare* Kahan & Kamar, *supra* note 138, at 1251 tbl.3 (reporting that 229,249 companies paid franchise tax in Delaware in 1999), *with* U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2002, at 471, http://www.census.gov/prod/2003pubs/02statab/business.pdf (reporting that 4,936,000 companies filed tax returns in the United States in 1999).

162. *See* Robert Daines, *Does Delaware Law Improve Firm Value*?, 62 J. FIN. ECON. 525, 526–27 (2001) (noting that public companies that incorporate in Delaware tend to have higher total assets than companies that incorporate in other states).

163. *See* Bebchuk & Roe, *supra* note 8, at 143–47 (arguing that entrenched participants in firms may block even efficient structural changes if these changes would harm them). Not all firms will be deadlocked by such divergence of interests because some could buy the consent of the participant blocking the reincorporation. *See* Hansmann & Kraakman, *supra* note 9, at 460–64. Time will tell how many firms will fall under this category.

164. *See* Hickok & Schürrle, *supra* note 16; Latham & Watkins, *Inspire Art*: New Opportunities for Corporate and Private Equity Structuring (2004) (client memorandum), http://www.lw.com/resource/Publications/_pdf/pub931_1.pdf.

165. Both existing and proposed European Union legislation protects vested rights of creditors and employees of companies that merge with foreign companies or reincorporate abroad. *See* Directive 2005/56/EC of the European Parliament and of the Council of 25 November 2005 on Cross-Border Mergers of Limited Liability Companies, arts. 4, 16, O.J. (L 310) 1 (EC); Council Regulation 2157/2001, arts. 8(7), 24(1), 34, 2001 O.J. (L 294) 5, 8, 11 (EC); Council Directive 2001/86, art. 7, 2001 O.J. (L 294) 27 (EC); Company Law: Commission Consults on the Cross Border Transfer of Companies' Registered Offices, IP/04/270, *available at* http://ec.europa.eu/internal_market/company/seat-transfer/index_en.htm (follow "Press release" hyperlink) [hereinafter Reincorporation Consultation].

limited their discretion.[166] They would not even need to sue to block the reincorporation. They would simply not initiate it.

Finally, even large public companies with no internal opposition to incorporation abroad might favor domestic incorporation in order to use their local clout for shaping corporate law or in order to avoid the jurisdiction of foreign courts and regulators.

These immobile firms would benefit from the competition for incorporations only if they happen to be located in member states that would compete for incorporations more than they compete today for investments. But since competition for incorporations would likely involve mainly small jurisdictions, few firms would fall under this category.[167] Other immobile firms would fare worse than they do now because mobile firms in their member states would incorporate abroad, leaving behind them smaller networks of domestic incorporations and legislatures with fewer reasons to maintain the quality of local corporate law.

While it is easy to identify the advantages and disadvantages of the current competition for investments in the European Union compared to competition for incorporations—the gain to immobile firms from the wider spread of competition and the loss to mobile firms from the ban on incorporation abroad—it is hard to assess which effect dominates. On the one hand, there are probably many more immobile firms than mobile firms. That only a fraction of American firms incorporate in Delaware while operating in other states suggests as much. On the other hand, immobile firms tend to need corporate law less than mobile firms, and indeed their lower willingness to pay for corporate law can account for their immobility. This explains why Delaware attracts less than five percent of incorporations by private firms but roughly half of the incorporations by public firms, and why it charges the latter much higher taxes.[168] The inability to determine which type of competition is socially more desirable, however, leaves open a more practical comparison between the current competition for investments, in which firms cannot incorporate abroad, and the regulatory dynamics that will develop once this freedom is introduced. The insights acquired above will inform this inquiry. We shall turn to it next.

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166. The Sarbanes-Oxley Act of 2002, which has been criticized in the United States on these grounds, is commonly viewed as the main reason for the decline in the popularity of American stock listing among foreign issuers. *See* Silvia Ascarelli, *Citing Sarbanes, Foreign Companies Flee U.S. Exchanges*, WALL ST. J., Sept. 20, 2004, at C1; Craig Karmin & Kate Kelly, *For Stock Listings, the U.S. Pull Gets Weaker*, WALL ST. J., Nov. 12, 2002, at C1; Andrew Parker & Tony Tassell, *Rank Could Look at US Delisting*, FIN. TIMES (London), Dec. 1, 2004, at 19; Bob Sherwood, *Long Arm of the US Regulator*, FIN. TIMES (London), Mar. 10, 2005, at 14.

167. *See* U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES, 2004–2005, at 21, *available at* http://www.census.gov/prod/www/statistical-abstract-2001_2005.html (ranking Delaware as the sixth smallest jurisdiction in population); *id.* at 213 (ranking Delaware as the third smallest jurisdiction in area); *id.* at 428 (ranking Delaware as the ninth smallest jurisdiction in gross state product).

168. *See* Kahan & Kamar, *supra* note 138, at 1251.

B. THE EFFECTS OF FREEDOM TO INCORPORATE ABROAD ON THE COMPETITION FOR INVESTMENTS

Comparing the social welfare implications of the current competition for investments in the European Union with those of competition for incorporations is only the first step toward informing the debate about the desirability of firm choice in the European Union or, indeed, anywhere else. To be sure, with the European Court of Justice expressing growing impatience with member states that do not recognize foreign corporations, and with the European Commission proposing a directive that would lift existing barriers to cross-border reincorporation, the freedom to pick any member state as a place to incorporate seems to be just around the corner for European Union companies. But allowing firms to incorporate abroad will not necessarily replace the current competition for investments by competition for incorporations. It may just as well weaken the competition for investments without introducing any substitute or, more plausibly, it may have no effect because immobile firms and market players that have adapted to recent reforms will preserve the current momentum in corporate lawmaking independent of competition for incorporations.

1. The Incentives to Compete

While the ability to incorporate abroad may or may not accelerate the development of national corporate laws or make them more favorable to shareholders by fostering competition for incorporations, it may lead to the opposite result by discouraging member states from using corporate law to compete for investments. Member states should have fewer reasons to worry about the quality of their corporate law once firms become free to choose where to incorporate because local corporate law will matter less than it does now to their prosperity. This appears to be the case in the United States. New York corporate law, for example, imposes personal liability on the ten largest shareholders of a company for unpaid salaries and wages.[169] Investors consider this rule highly unattractive.[170] But this does not prevent New York from being one of the most prosperous states and home to numerous companies; many of these companies simply incorporate in Delaware instead of New York.

Thus, while the freedom to choose where to incorporate will make the regulatory dynamics in the European Union more like those in the United States, ironically this may weaken, rather than strengthen, the incentives that member states have to develop their corporate law. Fewer firms will remain incorporated domestically, and these firms will tend to depend on the law less

169. *See* N.Y. BUS. CORP. LAW § 630(a) (McKinney 2003) ("The ten largest shareholders . . . shall jointly and severally be personally liable for all debts, wages, and salaries due . . . .").

170. *See* Frederick Attea, *State Has Hard Time Following a Lead*, BUS. FIRST OF BUFFALO, Apr. 17, 2000, at 30 (noting that shareholder liability for wages and salaries is the main reason why many New York businesses incorporate in Delaware); Michael M. Membrado & Christopher J. Gulotta, *Navigating the Formation of Start-Up Companies*, N.Y. L.J., Sept. 18, 2000, at S6 (same).

than firms that revealed their dependence by incorporating abroad. Unless firms incorporated domestically need a different kind of law from that needed by firms incorporated abroad, their needs will likely receive less attention from lawmakers than they did prior to the departure of their peers.[171]

This analysis above outlines one possible outcome of the introduction of firm ability to incorporate abroad. It does not purport to predict the only possible outcome. The outcome may be different, for example, if the last decade of competition for investments has created institutional dynamics that will perpetuate the current pace and direction of corporate lawmaking. The outcome may also be different if a substantial number of companies face hurdles to incorporating abroad. Nevertheless, to the extent that the present momentum of corporate lawmaking persists, it will do so despite the new mobility, not because of it.

One mechanism that could sustain the existing momentum is adaptation of the market to the changed legal environment.[172] The intense competition for investments that economic integration has fostered in the European Union has introduced actors who would want to see the current trend continued. In Italy, for example, many new business leaders, and more than one leader of the old business aristocracy, have jumped onto the corporate governance bandwagon;[173] foreign investment banks have entered the securities and mergers and acquisitions markets;[174] local banks have converted to the new gospel of shareholder capitalism;[175] and the recently privatized stock exchange has become a proponent of reform.[176] Similarly, in Germany, formerly creditor-oriented banks have embraced the corporate governance movement by shifting operations from corporate lending to investment banking;[177] formerly corporatist managers have become more attuned to shareholder value as a result of the growing popularity of stock option compensation;[178] and formerly insular employees have started

171. For the argument that countries can benefit from allowing local firms to piggyback more developed markets and corporate law abroad, see Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 273 (1998); Edward B. Rock, *Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Markets*, 2 THEORETICAL INQUIRIES L. 711, 712 (2001).

172. *See generally* Deeg, *supra* note 32.

173. *See* Fred Kapner, *An Emerging Generation of Business Leaders Is Promising to Sweep Away Secrecy and Cronyism*, FIN. TIMES (London), Apr. 7, 2003, at 19. The internalization of shareholder values by corporate managers, even if widespread, does not obviate the need for corporate law because the law helps managers to commit to these values.

174. *See Mediobanca on the Back Foot*, THE ECONOMIST, June 23, 2001, at 70 (stating that "international investment banks, and not the Italian banking aristocracy, now dominate business in Italy").

175. *See* Heather O'Brien, *IntesaBCI, Lazard Link in Italy*, DAILY DEAL, Sept. 10, 2002.

176. *See* Deeg, *supra* note 32, at 188.

177. *See supra* note 23.

178. *See* John W. Cioffi, *Building Finance Capitalism: The Regulatory Politics of Corporate Governance Reform in the United States and Germany*, *in* THE STATE AFTER STATISM: NEW STATE ACTIVITIES IN THE AGE OF LIBERALIZATION (Jonah D. Levy ed., forthcoming 2006) (describing the growing acceptance in the 1990s of shareholder primacy by managers of corporations with global operations, such as Daimler-Benz and Siemens).

to invest their own pension money in stock.[179] To be sure, the interests of these groups continue to diverge, but the gap between them is narrower than it used to be.[180]

The momentum can also be fueled by companies that will remain practically locked in their home member states notwithstanding the freedom to incorporate abroad.[181] As the freedom to choose where to incorporate will be of little relevance to them, these companies will continue to provide an impetus for their member states to keep updating the law and replicating shareholder protection available elsewhere. In the United States, many states maintain their corporate law for this reason. Some of these states are too big to mind the potential fiscal benefit from incorporations, and none of them bothers to structure its tax to capture this benefit.[182] They maintain their corporate law, and other areas of law, simply as a service to citizens.

2. The Effects on Firms

The freedom to incorporate abroad will be good news for companies whose costs of incorporating abroad are low and that are located anywhere other than the member state with the most attractive corporate law. These mobile firms will see their options expand and will be able to choose between incorporating in their home member states and incorporating in any other member state in which the law fulfills their needs. Since these firms will incur only low costs if they incorporate abroad, they could gain, but not lose, from their freedom. They will forgo the opportunity to incorporate abroad only if they do not really need it.

The effect of the freedom to incorporate on firms that do not take advantage of this freedom because doing so would be costly to them is more ambiguous. They will neither lose nor gain to the extent that lawmakers in their home member states maintain the quality of corporate law despite the outflow of incorporations by other local companies. But they will lose—up to their cost of incorporating abroad—to the extent that the incentives of lawmakers in their home member states suffer as a result of such corporate migration.

It is hard to tell which of these outcomes will materialize. One can reasonably predict, however, that even if the latter outcome occurs, the cost it will impose on firms that do not incorporate abroad will be smaller than the benefit it will confer on firms that do incorporate abroad. The reasons are twofold. First, lawmakers driven by the desire to stimulate the local economy will have a strong interest in maintaining the quality of corporate law if a significant

179. *See* John C. Cioffi & Martin Höpner, *Left-Wing Support for Shareholder Capitalism?*, 51 DIE MITBESTIMMUNG 58 (2005).

180. For a recent account of the persistence of old traditions in German corporate boards, see Patrick Jenkins, *The Clubby World of German Business Refuses to Accept New Membership Rules*, FIN. TIMES (London), Aug. 28, 2004, at 20 (reporting that "corporate governance reformers are failing in Germany").

181. *See supra* Part III.A.3.

182. *See* Kahan & Kamar, *supra* note 1, at 688–90.

number of local firms with a pressing need for it cannot incorporate abroad. Second, as both logic and experience in the United States suggest, firms that do incorporate abroad tend to have a greater need for corporate law than firms that incorporate locally.

Viewed from this perspective, the introduction of firm choice to the current competition for investments comes close to achieving the benefits of both competition for investments and competition for incorporations while avoiding the associated costs. Competition for investments without firm choice benefits companies that would face high costs of incorporating abroad. Competition for incorporations benefits companies that face low costs of incorporating abroad. Competition for investments combined with freedom to incorporate abroad, assuming this freedom does not significantly weaken the competition, benefits both types of firms.

3. Competition for Incorporations as a Complement

Ever since the possibility that firms in the European Union would be free to incorporate outside the jurisdiction in which they operate was first considered, one of the most debated questions among commentators has been whether the competition for incorporations, which to most commentators appeared inevitable, would advance or harm social welfare.[183] Today, since a recent series of decisions by the European Court of Justice has made the freedom to incorporate abroad a near reality,[184] this question is more relevant than ever.

However, it is not obvious that any member states will decide to compete for incorporations, given the high costs and low benefits of doing so. Rather telling in this regard is the fact that none of the member states regarded as potential competitors have positioned themselves to compete or have stated an intention of doing so. This inaction is notable considering the time that has passed since member states were put on notice that the days of the real-seat rule across the European Union were numbered following the recent decisions of the European Court of Justice.

In 1986, the European Court of Justice ordered the Dutch authorities to recognize a British company operating in the Netherlands.[185] The court reiterated its position to the Danish authorities, to the German authorities, and again to the Dutch authorities in subsequent decisions in 1999,[186] 2002,[187] and

183. *See supra* note 5.

184. *See supra* note 6 (describing landmark cases in which the European Court of Justice required member states to recognize companies incorporated abroad).

185. *See* Case 79/85, D.H.M. Segers v. Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen, 1986 E.C.R. 2375. A subsequent decision upholding British restrictions on the relocation to the Netherlands of the corporate headquarters of a company incorporated and headquartered in the United Kingdom caused temporary uncertainty about the direction that the court was taking. *See* Case 81/87, The Queen v. H.M. Treasury & Comm'rs of Inland Revenue *ex parte* Daily Mail & General Trust PLC, 1988 E.C.R. 5483.

186. *See* Case C-212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459.

2003.[188] A flurry of commentary examining the new reality from all possible angles quickly filled the pages of legal journals.[189] With the rewards of early entry being a lesson from Delaware's experience, one would have expected a mad rush to bid for foreign incorporations.[190] But member states showed no interest in competing. There was no mad rush—not even a lazy stroll. Member states will soon have no choice but to accept firm migration. The European Commission is already drafting a directive requiring them to do just that.[191] But compliance with this requirement should not be mistaken for competition for incorporations. European capitals may have already revealed their lack of interest in this regard during two decades of apathy.

Would competition for incorporations make a difference? Perhaps less than most would think. From the standpoint of migrating firms, the specific identity of the jurisdiction in which they incorporate is secondary to the quality of its law. With or without competition for incorporations, the freedom to incorporate abroad would allow firms to incorporate in any member state they choose. Whether it is a member state that competes for incorporations or one that competes for investments, by and large, its law will be the same.

IV. TOWARD A GENERAL THEORY OF COMPETITION FOR INVESTMENTS

The European Union is a case study of using corporate law to compete for investments. But there is nothing uniquely European about this competition. Given the right circumstances, it could develop elsewhere. In fact, it already developed in the United States. Earlier I noted that the ease with which American firms nowadays incorporate outside their home state reduces the importance of local corporate law to a state's economy.[192] But what if American firms did not enjoy this freedom? Would states then adopt corporate laws to attract capital? History shows that this is precisely what has happened.

Most modern accounts of state competition in corporate law begin the analysis in the late nineteenth century.[193] They recount how firms that had originally incorporated in New Jersey, the first state to commercialize its chartering business, reincorporated into Delaware to avoid New Jersey legislation preventing them from owning stock in other firms.[194] As New Jersey

187. *See* Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919.

188. *See* Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155.

189. *See supra* note 5.

190. *See* ROMANO, *supra* note 104, at 37–44; Klausner, *supra* note 160, at 841–47.

191. *See* Reincorporation Consultation, *supra* note 165.

192. *See supra* notes 169–70 and accompanying text.

193. An important exception is Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985). This Part draws on that article and the sources cited in it.

194. *See* ROMANO, *supra* note 104, at 42–43; Christopher Grandy, *New Jersey Corporate Chartermongering, 1875–1929*, 49 J. ECON. HIST. 677, 685 (1989); William E. Kirk, III, *A Case Study in Legislative*

became more industrialized, so the story goes, it no longer needed the fees these firms paid and passed the restrictive legislation with little regard for its effect on incorporations. Delaware, by contrast, was eager to increase its tax revenue and accepted reincorporated firms with open arms.[195]

This description, however, does not say what happened prior to this episode. Had it always been easy for firms to reincorporate in another state without moving their business? Had New Jersey always been the incorporation state of choice? To both questions, the answer is no. In the beginning of the nineteenth century, firms used to incorporate where they operated.[196] It was only with the shift to out-of-state incorporation during the nineteenth century that New Jersey assumed dominance.

Both practical and legal reasons explained why firms incorporated in their home state in the early years of the nineteenth century. The practical reason was the lack of modern transportation and communication.[197] The legal reasons were the common demand by states that chartered firms operate locally[198] and the absence of federal law recognizing out-of-state incorporations.[199]

In this environment, states that wished to lure business had to offer attractive corporate law. And they did. Competition for investments was instrumental in the advent of general corporation statutes,[200] the spreading of limited liabil-

Opportunism: How Delaware Used the Federal-State System to Attain Corporate Pre-Eminence, 10 J. CORP. L. 233, 246–58 (1984); Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249, 265–76 (1976).

195. *See* Romano, *supra* note 104, at 42–43; Grandy, *supra* note 194, at 688–91.

196. *See* Edwin Merrick Dodd, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 WITH SPECIAL REFERENCE TO MASSACHUSETTS 179, 400 n.29 (1954).

197. *See* Butler, *supra* note 193, at 154 (arguing that technological innovation overcame distance barriers to out-of-state incorporation); *see also* GEORGE R. TAYLOR, THE TRANSPORTATION REVOLUTION, 1815–1860 (1962); Richard B. Du Boff, *Business Demand and the Development of the Telegraph in the United States, 1844–1860*, 54 BUS. HIST. REV. 459 (1980).

198. *See* DODD, *supra* note 196, at 178–80; Edward Q. Keasbey, *New Jersey and the Great Corporations*, 13 HARV. L. REV. 198, 204 (1899); Harold W. Stoke, *Economic Influences upon the Corporation Laws of New Jersey*, 38 J. POL. ECON. 551, 562 (1930). The Central American Transit Company, for example, secured a New Jersey charter on condition that its principal depot was in Jersey City. *See* An Act to Recognize and Authorize the Organization of, and to Incorporate the Central American Transit Company § 2, ch. 187, 1862 N.J. Laws 328, 329–30. This stipulation was required under a general law from 1849. *See* An Act to Authorize the Establishment, and to Prescribe the Duties of Companies for Manufacturing and Other Purposes, 1849 N.J. Laws 300.

199. The watershed decision requiring states to allow foreign corporations to do inter-state business was *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1869). *See* HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 19 (2d ed. 1970) (describing the effect of the decision); *see also* GERARD CARL HENDERSON, THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW 116 (1918) (same).

200. *See* JOHN W. CADMAN, JR., THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS, 1791–1875, at 18–23, 35, 422–23 (1949) (attributing New Jersey's enactment of a general incorporation law for manufacturing companies in 1816, duplicating New York's law of 1811, to the intention "to encourage manufacturing in the midst of depression as the New York legislators had seemingly hoped to encourage it in anticipation of war").

ity,[201] and the liberalization of corporate laws.[202]

Thus, in 1826, Massachusetts Governor Levi Lincoln called on the legislature to limit shareholder liability for corporate debt, citing the large sums of money Massachusetts citizens had recently invested in factories in Maine and New Hampshire, where shareholders enjoyed limited liability.[203] A year later, the legislature passed a law exempting from liability shareholders who transferred their shares and entitling shareholders who paid a corporate debt for reimbursement by other shareholders.[204]

These changes were not enough given the large number of business failures in New England's textile industry in 1829.[205] In that year, local manufacturers warned the Massachusetts legislature in a widely-circulated petition that unlimited liability "tends to discourage the application of individual funds to the support of Manufacturing Establishments in this, and the diversion of *Millions of Capital* to other States," causing "the very great and rapid decline of all manufacturing stock in this Commonwealth, and the absolute ruin of many valuable establishments, that otherwise would have been sustained, and carried on successfully."[206]

A similar concern was voiced in an unsigned article published in a legal magazine:

> [Unlimited liability] has heretofore been introduced in the grant of charters for manufacturing purposes in Massachusetts. The effect has been to drive millions of capital into the neighboring states for investment. And there it will remain. It is questionable whether the recent alleviating act is an adequate remedy.[207]

Another unsigned article acknowledged there was no proof that unlimited

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201. *See* DODD, *supra* note 196, at 378–81; CAROLINE F. WARE, THE EARLY NEW ENGLAND COTTON MANUFACTURE: A STUDY IN INDUSTRIAL BEGINNINGS 148 (1931). Proponents of limited liability claimed a hundred years later that limited liability was essential for attracting capital to California. The claim was no longer credible, however, given the freedom to incorporate California businesses in another state and the fact that the proponents were lawyers who stood to lose clients as a result of such incorporations, rather than industrialists. *See* Mark I. Weinstein, *Limited Liability in California 1928–31: It's the Lawyers*, 7 AM. L. & ECON. REV. 439, 452–54 (2005).

202. *See* CADMAN, *supra* note 200, at 36–38, 174–77, 440 (discussing the efforts of lawmakers to attract business by encouraging incorporation); Stoke, *supra* note 198, at 553–55 (noting a trend of liberality).

203. *See* Message to the Senate and House of Representatives of the Commonwealth of Massachusetts (June 6, 1826), *in* 1826 Mass. Resolves 377, 383–84.

204. *See* An Act in Addition to the Several Acts Respecting the General Powers and Duties of manufacturing Corporations (Mar. 10, 1827), Mass. Laws, May Sess. 1825–Mar. Sess. 1828, ch. 137, p. 547.

205. *See* WARE, *supra* note 201, at 91–92.

206. Petition of Friends of American Industry and Home Manufactures to the Honorable Senate and House of Representatives in General Court Assembled, November 1829 (on file at the Commonwealth of Massachusetts Archives, in the bill jacket for Acts of 1830, ch. 103); *see also* WARE, *supra* note 201, at 148 (discussing the petition); DODD, *supra* note 196, at 378 (same).

207. *See Corporations*, 4 AM. JURIST 298, 307 (1830).

liability alone drove away investments, but suggested it was a contributing factor, saying:

> But what is the tendency of the system which has been pursued in Massachusetts? In other states the laws are less severe against stockholders. This must tend to attract capital from that state into others where it can be more safely invested. That this personal responsibility has, in fact, drawn manufacturing capital from Massachusetts, we do not affirm; for other causes may have operated to prevent this result. But the tendency is obvious, and it has been frequently asserted that the injurious consequences resulting from it are very great. It is sufficient, however, for us to show the tendency, since it is not to be taken for granted that Massachusetts will, in spite of these laws, always offer attractions for manufacturing capital superior to those of any of the surrounding territories.[208]

Governor Lincoln highlighted a related evil of unlimited liability. Not only did it deter investments by citizens of other states, he asserted in a message to legislators, but it also deterred investments by local citizens, creating a risk that "the manufacturing interest, to a great extent, must be abandoned in Massachusetts."[209]

The pressure produced its desired results with the enactment of the Manufacturing Corporations Act in 1830, which greatly restricted shareholder liability.[210] In the legislative debate, Representative Lowell backed the capital flight argument with figures. More than $7 million of Massachusetts money, he maintained, was invested in New Hampshire, where limited liability charters had been available for several years, and large Massachusetts investments were in Connecticut and New York, which also offered limited liability.[211]

Later in the century, proponents of granting New Jersey charters to firms owned by citizens of other states emphasized that "it is our policy to offer every facility to persons out of our state to come and work our mines for our benefit,"[212] and noted the large amount of New York and Pennsylvania capital that had been "attracted" to New Jersey "by liberal charters."[213] This claim was repeated by New Jersey Governor Theodore Randolph, who reminded lawmakers in 1869:

> The community that invites labor and capital within its borders by liberal legislation, adds to its own stability and enriches its citizens . . . .

208. *Manufacturing Corporations*, 2 AM. JURIST 92, 104 (1829).

209. *See* Message to the Senate and House of Representatives of the Commonwealth of Massachusetts (Jan. 6, 1830), *in* 1830 Mass. Resolves 212, 228–30.

210. *See* An Act Defining the General Powers and Duties of Manufacturing Corporations, Mass. Laws, May Sess. 1828–Mar. Sess. 1831, ch. 53, p. 325.

211. *See* DODD, *supra* note 196, at 380–81.

212. *See Legislature of New Jersey*, NEWARK DAILY ADVERTISER, Jan. 29, 1847, at 2 col.5.

213. *See Proceedings of the Legislature*, NEWARK DAILY ADVERTISER, Feb. 3, 1864, at 2 col.7.

> I feel assured you will fully appreciate the propriety of continuing that policy which has heretofore induced manufacturing enterprise and capital to seek our protection.[214]

The shareholder-friendly approach proved effective.[215] So effective, indeed, as to bring a member of the 1867 New York Constitutional Convention to observe with envy:

> One of the smallest States of the Union, with not more than two-thirds of her area susceptible of being devoted to agriculture, [New Jersey] has placed herself, by the aid of her location and corporations, as a power in the Union. Strip her of what her corporations have made her, the wealth and position she has obtained through them, and where would New Jersey be to-day?[216]

The above glimpse into history supports the general applicability of the analysis in this Article. Other examples from different times and different places surely exist. The ongoing corporate reform in Japan, for instance, resembles in many ways the developments in the European Union. Here too, recent laws tighten shareholder protection while deregulating other aspects of corporate law expressly to stimulate the economy and attract capital.[217] And, as in the European Union, it is firms in need of additional capital, and firms that rely on foreign investment, that take advantage of this change.[218] Far from being an isolated case, the regulatory dynamics in the European Union seem to follow a pattern that is old, perhaps even universal. Exploring the presence and nature of these dynamics in other times and places is a promising area for future research.

CONCLUSION

How different will member state laws be with freedom to incorporate but no competition for incorporations from what they could be with such competition? Perhaps not much.

Normally, the rate of legal innovation and diffusion—and the degree to which

214. *See* Inaugural Proceedings and Address of His Excellency, Theodore F. Randolph, 25th New Jersey Cong. 185–86 (1869) (statement of Gov. Randolph).

215. *See* CADMAN, *supra* note 200, at 37, 177.

216. *See* 2 PROCEEDINGS AND DEBATES OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF NEW YORK, HELD IN 1867 AND 1868, IN THE CITY OF ALBANY 1075 (1868).

217. *See generally* Tomotaka Fujita, *Modernising Japanese Corporate Law: Ongoing Corporate Law Reform in Japan*, 16 SING. ACAD. L.J. 321 (2004); Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343 (2005); Curtis J. Milhaupt, *A Lost Decade for Japanese Corporate Governance Reform?: What Has Changed, What Hasn't, and Why*, *in* INSTITUTIONAL CHANGE IN JAPAN (Magnus Blomström & Sumner J. La Croix eds., forthcoming 2006); Takaya Seki, *Legal Reform and Shareholder Activism by Institutional Investors in Japan*, 13 CORP. GOV. 377 (2005).

218. *See* Gilson & Milhaupt, *supra* note 217, at 357, 363 (reporting that foreign ownership and financial distress is common to the firms that have adopted an optional governance structure introduced in 2002).

the law serves shareholders—can be expected to be higher in jurisdictions that pursue incorporations. In the United States, for example, Delaware appears to be faster than other states in innovating and copying innovations from others. Other states are slower to adopt changes because they do not pay as much attention to their laws. Delaware also appears to be more careful in balancing shareholders' preferences against managers', as evidenced by its decision not to match the potent antitakeover statutes that some other states adopted with a similarly potent statute of its own.[219] Other states have more powerful antitakeover statutes because local managers lobby for their enactment while out-of-state shareholders are largely ignored.

Competition for capital currently provides member states with a stronger reason to update their laws and accommodate shareholders than does the hope of attracting incorporations. This motivation may weaken if incorporation abroad becomes an easy alternative for all firms to use. But to the extent that many firms find this option impractical—which is more likely to be the case in the European Union than it is in the United States—the need to support economic development by attracting foreign investment may continue the momentum of corporate innovation. This may compensate, and perhaps more than compensate, for the absence of competition for incorporations as a motivation to develop the law.

While the current regulatory dynamics in the European Union provide a particularly vivid illustration of the power of competition for investments to shape corporate law, these dynamics appear universal. They shaped corporate law in the United States in the nineteenth century, when firm mobility was limited, and likely shape corporate law in other parts of the world today.

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219. *See* ROMANO, *supra* note 104, at 59; Carney, *supra* note 154, at 754–55; Kahan & Kamar, *supra* note 1, at 740.