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Freedom of Choice in European Corporate Law

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I. INTRODUCTION

U.S. corporations are free to choose the state law governing their internal affairs,[1] a concept that this Article will refer to as free choice. The

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1. *See, e.g.*, ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 63 (2002) [hereinafter ROMANO, ADVANTAGE]; Alan E. Garfield, *Evaluating State Anti-Takeover Legislation: A Broadminded New Approach to Corporation Law or "A Race to the*

legal mechanism by which U.S. law ensures free choice is the state of incorporation doctrine.[2] Under that doctrine, the internal affairs of a corporation are governed by the law of the state of incorporation, regardless of where the corporation's headquarters are located.[3] At any time, therefore, corporations can change the state law which applies to them by choosing to reincorporate elsewhere.

The concept of free choice has long been the topic of intensive legal research. In particular, scholars have focused on the question of whether the freedom of corporations to choose between the law of different states will lead to more efficient rules. Amid the variety of positions that have been developed on this issue, the two most prominent ones are commonly known as the race-to-the-bottom and the race-to-the-top views.[4] While both assume that states compete for corporate charters in order to maximize the revenues derived from incorporation fees,[5] they differ as to the direction that such competition takes. Under the race-to-the-bottom view, states will compete for corporate charters not by making their corporate law more efficient, but by making their law more management-friendly.[6] Proponents of the race-to-the-top view reject

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Bottom"?, 1990 COLUM. BUS. L. REV. 119, 122. The term "internal affairs" refers to "the relations inter se of the corporation, its shareholders, directors, officers or agents." *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 41 cmt. a (1977).

2. The state of incorporation doctrine in the sense described above is also referred to as the "internal affairs doctrine." *See, e.g.*, David M. Majchrzak, Note, *Corporate Chaos: Who Should Govern Internal Affairs?*, 24 T. JEFFERSON L. REV. 83, 84 (2001); Note, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy*, 115 HARV. L. REV. 1480, 1480 (2002).

3. *See, e.g.*, Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, LAW & CONTEMP. PROBS., Summer 1985, at 161, 163. The Revised Model Business Corporation Act specifically endorses the state of incorporation rule. *See* MODEL BUS. CORP. ACT § 15.05(c) (1984) ("This Act does not authorize this state to regulate the organizations or internal affairs of a foreign corporation authorized to transact business in this state.").

4. Some scholars have suggested that there is neither a race to the bottom nor a race to the top. *See, e.g.*, Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks*, 43 KAN. L. REV. 541, 543 (1995) [hereinafter Ayres, *Supply-Side Inefficiencies*] (suggesting that even under the assumption that managers demand value-maximizing corporate law, the results yielded by state competition may not be optimal).

5. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 684 (1974); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 233 (1985) [hereinafter Romano, *Law as a Product*].

6. As early as 1933, Justice Brandeis claimed that competition among states for corporate chartering revenues was a race "not of diligence but of laxity." Louis K. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting). William L. Cary later coined the phrase "race for the bottom." Cary, *supra* note 5, at 666. *See also* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1440 (1992) [hereinafter Bebchuk, *Desirable Limits*] ("[S]tate competition causes a race for the top with respect to some corporate issues but a race for the bottom with respect to others."); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 130 (2001) [hereinafter Bebchuk & Ferrell, *New Approach*] (arguing that state competition leads states to protect managers from takeovers to an inefficient extent); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race To Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999) [hereinafter Bebchuk & Ferrell, *Federalism*] (claiming that state competition probably does not maximize shareholder wealth); Joel Seligman, *The Case for Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 971-74 (1990) (suggesting federal corporate law norms for Congress in three specific areas); Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 60-63 (1993) (suggesting partial federalization of corporate law); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1801 (2002) (taking the view that the federal government should play a greater role in the area of corporate law).

that reasoning, claiming that it neglects the influence exerted by capital markets. Managers, they argue, have a strong incentive to make the corporation's shares attractive to shareholders, lest capital markets punish the corporation and—by extension—its managers.[7]

In the European Community, the debate over free choice has, at least until recently, rarely inspired close scrutiny.[8] This is unsurprising, given that the ability of corporations to choose the applicable corporate law regime has long faced a formidable obstacle in the so-called real seat doctrine. Under this doctrine, which prevailed until recently in many Member States of the European Community,[9] the internal affairs of a corporation are governed not

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7. This view was first advanced by Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). *See also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 222 (1991) (arguing that while there may not be a race to the top, competition nevertheless creates a "powerful tendency" to enact laws that work to the advantage of shareholders); ROMANO, ADVANTAGE, *supra* note 1, at 63-64 (noting that "shareholders, on balance, benefit from competition"); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 16 (1993) [hereinafter ROMANO, GENIUS] (citing research showing that state competition "benefits rather than harms shareholders"); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980) (taking the view that investors are not harmed when corporations reincorporate in Delaware); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 542 (1984) (arguing that state competition benefits investors); Daniel R. Fischel, *From MITE to CTS: State Anti-Takeover Statutes, the Williams Act, the Commerce Clause, and Insider Trading*, 1987 SUP. CT. REV. 47, 84 (claiming that inefficient state laws will cause businesses to incorporate elsewhere); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919-20 (1982) (arguing that state competition maximizes shareholder wealth); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 119 (1992) (showing that state competition can benefit shareholders); Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 847 (1993) [hereinafter Romano, *Lesson*] (arguing that state competition benefits investors "on balance"); Romano, *Law as a Product, supra* note 5, at 225 (finding that reincorporation in Delaware "is associated, in some situations, with positive abnormal returns for the shareholders"); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1528 (1989) (expressing confidence in the view that the race-to-the-bottom view of state competition is incorrect).

8. *But see* ROMANO, GENIUS, *supra* note 7, at 128-40 (explaining the absence of a market for corporate charters in Europe); David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423 (1991) (stressing the role of the real seat doctrine in preventing the emergence of a market for corporate charters in the Community); Clark D. Stith, Note, *Federalism and Company Law: A "Race to the Bottom" in the European Community*, 79 GEO. L.J. 1581, 1618 (1991) (arguing that the European Community has to fear a race to the bottom).

9. *See, e.g.*, ROMANO, GENIUS, *supra* note 7, at 132. Among the European countries that have traditionally applied the real seat doctrine are Austria, Belgium, France, Germany, Greece, Luxembourg, Portugal, and Spain. *See* Bernhard Großfeld, *Internationales Gesellschaftsrecht [Corporate Conflict of Laws]*, *in* J. VON STAUDINGERS KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH MIT EINFÜHRUNGSGESETZ UND NEBENGESETZEN: EGBGB/IPR 42-43 (Christian von Bar et al. eds., 1998); Werner F. Ebke, *Centros—Some Realities and Some Mysteries*, 48 AM. J. COMP. L. 623, 646 (2000). Italy applies its own corporate law both to corporations that have their real seat in Italy and to corporations that have been incorporated in that country. *See* Großfeld, *supra*, at 42-43. By contrast, Denmark, Ireland, the Netherlands, and the United Kingdom apply the state of incorporation doctrine. *See* Karsten Engsig Sørensen & Mette Neville, *Corporate Migration in the European Union: An Analysis of the Proposed 14th EC Company Law Directive on the Transfer of the Registered Office of a Company from One Member State to Another with a Change of Applicable Law*, 6 COLUM. J. EUR. L. 181, 185 (2000); Subramanian, *supra* note 6, at 1869-70 n.272. The same is said to be true of Finland and Sweden. *See* Paul Krüger Andersen & Karsten Engsig Sørensen, *Free Movement of Companies from a Nordic Perspective*, 6 MAASTRICHT J. EUR. & COMP. L. 47, 54-56 (1999). However, there does not seem to be any case law or statutory law settling the issue with regard to Swedish and Finish law. *See id.*

by the law of the state of incorporation but by the law of the state where the corporation's headquarters are located. As a result, corporations cannot choose the law of another Member State unless they are willing to move their headquarters as well.[10] Since the costs of such a move will usually outweigh the advantages connected with a more efficient corporate law regime,[11] the real seat doctrine effectively prevents free choice.

More recently, however, this situation has changed profoundly. Two decisions by the European Court of Justice (ECJ), *Centros*[12] and *Überseering*,[13] have made it clear that the real seat rule, as traditionally applied by many Member States of the European Community, is incompatible with the Freedom of Establishment guaranteed by the Treaty establishing the European Community (EC Treaty).[14] Of course, the real seat rule, which gives the real seat state a regulatory monopoly vis-à-vis the corporation's internal affairs, is only one of two ways in which free choice can be eliminated. The other method is the imposition of a uniform "federal" corporate law regime.[15]

As a result of the demise of the real seat rule, the Community now faces the same question with which the United States has long been grappling: should free choice be the principle underlying corporate law, or should free choice give way to a uniform corporate law regime? This Article seeks to answer that question with respect to the European Community. It argues that free choice can be expected to yield greater benefits than the complete or partial harmonization of the corporate law regimes of Europe. Moreover, while European corporations may remain less mobile than their U.S. counterparts, the efficiency gains to be derived from free choice in Europe may well exceed those reaped in the United States.

The view that the Community should adopt free choice in corporate law is hardly new. There is no shortage of literature dealing with the issue, and both opponents and advocates of free choice can be readily located.[16]

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at 56.

10. *See, e.g.*, ROMANO, GENIUS, *supra* note 7, at 132.

11. *See, e.g.*, William J. Carney, *Federalism and Corporate Law: A Non-Delaware View of the Results of Competition*, *in* INTERNATIONAL REGULATORY COMPETITION AND COORDINATION 153, 169 (William Bratton et al. eds., 1996); Daniel C. Esty & Damien Geradin, *Regulatory Co-Opetition*, 3 J. INT'L ECON. L. 235, 243 (2000).

12. Case 212/97, Centros Ltd. v. Erhvers- og Selskabsstyrelsen, 1999 E.C.R. I-1459, [1999] 2 C.M.L.R. 551 (1999).

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

14. See *Centros*, 1999 E.C.R. I-1459, para. 40, [1999] 2 C.M.L.R. 551, 588 (1999); *Überseering*, 2002 E.C.R. I-9919, paras. 94-95.

15. This Article uses the term "federal" in a non-technical sense, namely, as an expression that includes both the federal level in the United States and the Community level in the European Community. This is not to imply that the European Community has become a federal state. Indeed, according to the prevailing view, the European Community has not yet reached the status of a federal state. *See, e.g.*, Manfred Zuleeg, *What Holds a Nation Together? Cohesion and Democracy in the United States of America and in the European Union*, 45 AM. J. COMP. L. 505, 507 (1997).

16. *See, e.g.*, Wolfram Bechtel, *Parteifähigkeit trotz Verlegung des Gesellschaftssitzes nach Deutschland* [*Capacity To Be a Party to Legal Proceedings Despite a Transfer of a Corporation's Real Seat to Germany*], 4 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT [NZG] 21, 23 (2001) (expressing concern about a race to the bottom in European corporate law); Werner F. Ebke, *Unternehmensrecht und Binnenmarkt—E pluribus unum?* [*The Law of the Enterprise and the Internal Market—E Pluribus Unum?*], 62 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALS PRIVATRECHT [RABELSZ] 195, 234-237 (1998) (arguing that state competition may not bring about efficient results even in the

However, most of the relevant publications give little consideration to how circumstances in Europe might differ from those in the United States. Only a handful of publications address the latter, and even those tend only to point out the more obvious barriers to free choice. Older works, for example, tend to stress the role of the real seat doctrine.[17] More recent publications, on the other hand, usually focus on the Community rules in the area of taxation, which prevent the state of incorporation from imposing franchise taxes on domestic corporations that are headquartered elsewhere.[18] They also point out that under the present legal system it is often impossible—or at least difficult—for European corporations to reincorporate without having their hidden reserves taxed.[19] These are important and fundamental obstacles. They explain both why European corporate law has not been characterized by state competition in the past and why such competition is unlikely to attain U.S. proportions if the present legal regime is retained. The debate, however, should not stop here. From a policy perspective, the decisive issues are different ones: given suitable legislative measures, to what degree can free choice be realized in the European Community?[20] Moreover, assuming that

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long run); Horst Eidenmüller & Stefan Grundmann, *Wettbewerb der Regelgeber im Europäischen Gesellschaftsrecht—jedes Marktsegment hat seine Struktur* [*Regulatory Competition in the European Community—Every Market Segment Has Its Structure*], 30 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 783, 832 (2001) (calling for regulatory competition in corporate law but noting that market failures should be minimized); Martin Heidenhain, *Ausländische Kapitalgesellschaften mit Verwaltungssitz in Deutschland* [*Foreign Corporations with a Real Seat in Germany*], 5 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT [NZG] 1141, 1142 n.13 (2002) (suggesting that a race to the top in European Corporate law is more likely than a race to the bottom); Gerold Jaeger, *Kapitalgesellschaften in der EU—dauerhaft Niederlassungsberechtigte zweiter Klasse?* [*Corporations in the EU—Permanently Enjoying a Second-Rate Freedom of Establishment?*], 3 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT [NZG] 918, 922 (2000) (warning of a race to the bottom in European corporate law); Marcus Lutter, *Das Europäische Unternehmensrecht im 21. Jahrhundert* [*The European Company Law in the 21st Century*], 29 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 1, 8-9, 16 (2000); Wolfgang Schön, *Mindestharmonisierung im europäischen Gesellschaftsrecht* [*Minimum Harmonization in European Corporate Law*], 160 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT [ZHR] 221, 235 (1996) (noting that it is unclear whether the adoption of the state of incorporation doctrine would lead to a race to the top or a race to the bottom); Christiaan W.A. Timmermans, *Die europäische Rechtsangleichung im Gesellschaftsrecht* [*The European Harmonization of Laws in the Field of Corporate Law*], 48 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALS PRIVATRECHT [RABELSZ] 1, 14 (1984) (noting that the prevention of a "Delaware effect" has from the beginning been the aim of harmonization efforts in the field of corporate law and emphasizing that the possibility of such a Delaware effect is still not completely precluded).

17. *See, e.g.*, ROMANO, GENIUS, *supra* note 7, at 132; John C. Coffee, Jr. et al., *The Direction of Corporate Law: The Scholars' Perspective*, 25 DEL. J. CORP. L. 79, 92 (2000); Sørensen & Neville, *supra* note 9, at 207; Stith, *supra* note 8, at 140.

18. *See, e.g.*, EVA-MARIA KIENIGER, WETTBEWERB DER PRIVATRECHTSORDNUNGEN IM EUROPÄISCHEN BINNENMARKET [COMPETITION OF PRIVATE LEGAL SYSTEMS IN THE EUROPEAN INTERNAL MARKET] 188-190 (2002) [hereinafter KIENIGER, WETTBEWERB] (pointing out that Community law bars the Member States from imposing franchise taxes on pseudo-foreign corporations). Other authors simply mention that the Member States do not impose franchise fees without noting that Community law prohibits them from doing so. *See, e.g.*, Catherine Holst, Note, *European Company Law After* Centros*: Is the EU on the Road to Delaware?*, 8 COLUM. J. EUR. L. 323, 336 (2000); Sørensen & Neville, *supra* note 9, at 208.

19. *See, e.g.*, Coffee, *supra* note 17, at 92; Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 356 (2001); Joseph A. McCahery & Erik P.M. Vermeulen, *The Evolution of Closely Held Business Forms in Europe*, 26 IOWA J. CORP. L. 855, 863 (2001). The term "hidden reserves" in this context refers to the difference between the market value of the corporation's assets and their value for tax accounting purposes.

20. As will be explained below, *see infra* text accompanying notes 170-185 many of those Member States that are unlikely to dominate the market for corporate charters can be expected to take

appropriate legislative measures are adopted, can free choice be organized in such a way as to yield more benefits than harmonization? These are the questions explored in this Article.

Part II examines the degree to which it is possible for the Community to create the legal and practical preconditions for free choice. Despite the ECJ rulings in *Überseering* and *Centros*, a range of practical and legal obstacles to free choice remain in place. At least some of these obstacles are likely to persist. However, appropriate legislative measures can ensure that the ability of European corporations to choose the applicable corporate law freely does not lag too far behind that of their U.S. counterparts. Part III argues that free choice in corporate law can be expected to be more efficient than harmonization and that the benefits of free choice may be more substantial in the Community than they are in the United States.

Two clarifications regarding the scope of the analysis are in order. First, the discussion undertaken in this Article will accept as a given the legal framework provided by the so-called primary EC law, which includes the Treaty Establishing the European Community (EC Treaty) and its protocols.[21] In other words, the possibility that the Treaty might be changed in order to facilitate free choice or harmonization will be disregarded. Second, in discussing the benefits and drawbacks of free choice, the Article will concentrate on the goal of maximizing shareholder wealth. The underlying assumption is that a corporate law regime focused on the maximization of shareholder wealth is also best suited to maximize the welfare of society as a whole.[22] Of course, there may be cases where this assumption proves mistaken, because certain corporate law rules produce positive or negative

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steps aimed at preventing local corporations from incorporating elsewhere. At the same time, the Member States play a decisive role in the legislative process at the Community level. One might question, therefore, whether it makes much sense to discuss the efficiency of free choice under the assumption that the competent Community institutions will facilitate free choice, given that many Member States have an interest in preventing free choice. However, the incentives that the Member States face in taking coordinated action via the Council—the institutional body within the EC through which representatives appointed by Member State governments vote on proposed legislation—are very different from the incentives they face when acting individually. Once the Member States coordinate their legislation via the Council, those Member States profiting from charter competition can compensate their less successful counterparts for any adverse consequences suffered as a result of free choice by making concessions in other areas. While it is not clear that such bargains *will* be reached, the important point is that they *may* be reached.

21. CONSOLIDATED VERSION OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Dec. 24, 2002, O.J. (C 325) 33, 2002 [hereinafter EC TREATY]. According to Article 311, the protocols annexed to this Treaty by common accord of the Member States shall form an integral part thereof. EC Treaty art. 311. That includes the Statute of the Court of Justice, which is annexed to the Treaty as a Protocol. Statute of the Court of Justice of the European Community, art. 20, 298 U.N.T.S. 147, as amended by Council Decision 88/591, O.J. C 215/1 (Aug. 21, 1989). To be sure, the Statute of the Court of Justice is somewhat easier to amend than the EC Treaty. According to Article 245, the Council, acting unanimously at the request of the ECJ and after consulting the European Parliament and the Commission, or at the request of the Commission and after consulting the European Parliament and the Court of Justice, may amend the provisions of the Statute, with the exception of Title I. EC TREATY art. 245. However, the difficulties of reaching a unanimous consensus among the 15—and soon 25—Member States of the European Community are so substantial that it appears justified to treat the Statute of the Court as a permanent fixture.

22. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001) (noting a "convergence on a consensus that the best means to . . . the pursuit of aggregate social welfare . . . is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests").

externalities for third parties. The rules governing shareholder liability for corporate torts, if considered to be part of corporate law,[23] provide an obvious example, given that a rule of limited liability for corporate torts shifts part of the costs of the corporation's economic activities from the corporation to the tort victims.[24] However, even if there are *some* corporate rules that produce externalities, their existence should not be determinative when making the fundamental choice between harmonization and free choice. Although these externalities may suggest a preference for harmonization, this is not a necessary outcome; one can always allow specific exceptions to the general rule that corporations should be free to choose the applicable corporate law.

II. CAN THE EUROPEAN COMMUNITY GRANT FREE CHOICE?

It only makes sense to analyze the benefits and drawbacks of free choice if there is a real possibility that such a regime could be established in the European Community. At present, European corporations wishing to choose the corporate law regime they find most efficient face a number of legal and practical obstacles.

A. *The Real Seat Rule*

The most important—and most well-known—legal obstacle to free choice in the European Community has traditionally been the real seat doctrine.[25] The real seat doctrine can have harsh consequences for a corporation moving its headquarters from one Member State to another. For example, if an English company moves its headquarters to Germany without reincorporating under German law, German courts will usually treat the organization as a partnership and subject all shareholders to unlimited liability.[26] The legality of the real seat rule under Community law has long been in doubt. Article 34 of the EC Treaty gives European citizens the right to establish themselves in the territory of other Member States,[27] and Article 48 extends that right to corporations.[28] In addition, European scholars have for some time been discussing whether the real seat rule is compatible with the

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23. *But see* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1916 (1991) (suggesting that shareholder liability for corporate torts should be seen as a problem of tort law rather than of corporate law).

24. *See id.* at 1888 (pointing out that the losses imposed on tort victims amount to subsidies for corporations).

25. Scholars have traditionally pointed to the real seat doctrine to explain the lack of a European market for corporate charters. *See supra* note 17.

26. *See, e.g.*, Gerfried Fischer, *Haftung für Scheininlandsgesellschaften* [*The Liability for Debts of Pseudo-National Corporations*], 11 PRAXIS DES INTERNATIONALEN PRIVAT- UND VERFAHRENSRECHTS [IPRAX] 100, 101 (1991); Wulf-Henning Roth, *From* Centros *to* Überseering*: Free Movement of Companies, Private International Law, and Community Law*, 52 INT'L. & COMP. L.Q. 177, 179 (2003).

27. *See* EC TREATY art. 43 ("Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited.").

28. *See* EC TREATY art. 48 ("Companies . . . formed in accordance with the law of a Member State and having their registered office . . . within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.")

Freedom of Establishment;[29] some of these scholars argue that it is not.[30] In *Centros*[31] and *Überseering*,[32] the ECJ made it clear that it shares that view.[33]

It should be noted, however, that the rights granted by the fundamental freedoms[34] are not absolute. Under the so-called imperative requirements doctrine,[35] national measures restricting the fundamental freedoms are compatible with Community law if four conditions are met: (1) they are applied in a non-discriminatory manner; (2) they are justified by imperative requirements in the general interest; (3) they are suitable for securing the attainment of the objective which they pursue; and (4) they do not go beyond what is necessary in order to attain it.[36] In determining whether a measure is justified by an imperative requirement, the Court uses a balancing test.[37]

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29. *See, e.g.*, DOMINIK SCHNICHELS, REICHWEITE DER NIEDERLASSUNGSFREIHEIT [THE SCOPE OF APPLICATION OF THE FREEDOM OF ESTABLISHMENT] 155-199 (1995) (arguing that the real seat doctrine violates the Freedom of Establishment); Rainer Deville, *Anmerkung zum Beschluß des Bayerischen Obersten Landesgerichts vom 18.7.1985—BReg. 3Z 62/85 [A Comment On the Decision of the Bavarian Supreme Court of July 18, 1985—BReg. 3Z 62/85]*, 32 RECHT DER INTERNATIONALEN WIRTSCHAFT [RIW] 298, 298 (1986) (arguing that the real seat doctrine does not violate the Freedom of Establishment); Carsten Thomas Ebenroth, *Neuere Entwicklungen im deutschen internationalen Gesellschaftsrecht [Recent Developments Regarding the German Rules Governing Conflicts of Laws in the Field of Corporate Law]*, 43 JURISTENZEITUNG 18, 24 (1988) (suggesting that the real seat doctrine does not violate Article 43); Bernhard Großfeld, *Die Sitztheorie des Internationalen Gesellschaftsrechts in der Europäischen Gemeinschaft [The Real Seat Rule in the Corporate Conflict of Laws in the European Community]*, 6 PRAXIS DES INTERNATIONALEN PRIVATRECHTS [IPRAX] 145, 145 (1986) (arguing that the real seat doctrine does not violate Article 43).

30. *See, e.g.*, SCHNICHELS, *supra* note 29, at 198.

31. *See generally* Case 212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459, [1999] 2 C.M.L.R. 551 (1999).

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

33. Thus, in *Überseering*, the Court held that

> [w]here a company formed in accordance with the law of a Member State ("A") in which it has its registered office exercises its freedom of establishment in another Member State ("B"), [the freedom of establishment] require[s] Member State B to recognize the legal capacity and, consequently, the capacity to be a party to legal proceedings which the company enjoys under the law of its State of incorporation ("A").

Id. para. 95.

34. In the EU context, "fundamental freedoms" refers to the five internal market freedoms: the Free Movement of Goods, the Free Movement of Workers, the Freedom to Provide Services, the Freedom of Establishment, and the Free Movement of Capital.

35. The "mandatory requirement" or "imperative requirement" doctrine was first developed in the so-called *Cassis de Dijon* decision with regard to the Free Movement of Goods. *See* Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung für Brantwein, 1979 E.C.R. 649, [1979] 3 C.M.L.R. 494 (1979). However, the ECJ soon began to use a similar reasoning with regard to the Freedom of Establishment. *See, e.g.*, Case 250/95, Futura Participations SA & Singer v. Admin. des Contributions, 1997 E.C.R. I-2471, para. 31, [1997] 3 C.M.L.R. 483, 506 (1997) (the effectiveness of fiscal supervision constitutes an "overriding requirement of general interest" capable of justifying restrictions on the exercise of fundamental freedoms guaranteed by the Treaty); Case 106/91, Ramrath v. Ministre de la Justice, 1992 E.C.R. I-3351, para. 29, [1992] 3 C.M.L.R. 173, 192 (1992) (freedom of movement for persons may be restricted only by rules which are "justified in the general interest"); Case 71/76 Thieffry v. Conseil de l'ordre des avocats à la Cour de Paris, 1977 E.C.R. 765, para. 15, 2 C.M.L.R. 373, 403 (1977) ("Freedom of establishment, subject to observance of professional rules justified by the general good, is one of the objectives of the Treaty.").

36. *See, e.g.*, Case 294/00, Deutsche Paracelsus Schulen für Naturheilverfahren GmbH v. Grabner, 2002 E.C.R. I-6515, para. 39; Case 108/96, Criminal Proceedings Against MacQuen, 2001 E.C.R. I-837, para. 26, [2002] 1 C.M.L.R. 853, 875 (2002); Case 212/97, Centros Ltd v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459, para. 34, [1999] 2 C.M.L.R. 551, 586 (1999).

37. *See, e.g.*, Case 470/93, Verein gegen Unwesen in Handel und Gewerbe Köln v. Mars GmbH, 1995 E.C.R. I-1923, para. 15, [1995] 3 C.M.L.R. 1, 14 (1995) (noting that the restrictions

The ECJ has made it clear that the imperative requirements doctrine also applies in the area of corporate law. In *Überseering*, the Court stated: "It is not inconceivable that overriding requirements relating to the general interest, such as the protection of the interests of creditors, minority shareholders, employees and even the taxation authorities, may, in certain circumstances and subject to certain conditions, justify restrictions on the freedom of establishment."[38] In a more recent judgment, the *Inspire Art* case,[39] the Court applied the imperative requirements doctrine in a fairly restrictive manner. There, the Court was faced with a so-called pseudo-foreign corporation statute enacted by the Dutch parliament.[40] A "pseudo-foreign corporation" is a corporation that is incorporated in another jurisdiction but has no significant contacts with that other jurisdiction.[41] A pseudo-foreign corporation statute declares some or all of the jurisdiction's corporate law to be applicable to the internal affairs of pseudo-foreign corporations.[42] The Dutch statute imposed, *inter alia*, certain minimum capital requirements and subjected corporate managers to personal liability where the relevant requirements were not met. According to the Court, these provisions were not justified by imperative requirements and therefore violated the Freedom of Establishment.[43] Whether the Court will pursue a similarly strict approach in future cases remains to be seen.

At first glance, the legal situation in the Community does not seem entirely unlike its counterpart in the United States. In the United States, any attempt to regulate the internal affairs of pseudo-foreign corporations faces scrutiny under the Commerce Clause, and the application of the latter usually entails the use of a balancing test.[44] Furthermore, the uncertainty concerning the extent to which the Member States of the European Community can regulate the internal affairs of pseudo-foreign corporations is paralleled in the U.S. legal system.[45] While some states have chosen to apply parts of their corporate law to certain types of pseudo-foreign corporations,[46] the legality of that course of conduct has never been entirely resolved.[47]

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imposed must be "proportionate to the objective pursued").

38. *Id.* para. 93.

39. Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd, 24 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 1885 (2003).

40. *Id.* at 1886 para. 27.

41. *See, e.g.*, Christian Kersting, *Corporate Choice of Law—A Comparison of the United States and European Systems and a Proposal for a European Directive*, 28 BROOK. J. INT'L L. 1, 1 (2002).

42. *See, e.g.*, Hartwin Bungert, *Equal Protection for Foreign and Alien Corporations: Towards Intermediate Scrutiny for a Quasi-Suspect Classification*, 59 MO. L. REV. 569, 663-64 (1994).

43. Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 24 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 1885, 1893 para. 142 (2003).

44. *See* Edgar v. MITE Corp., 457 U.S. 624, 643 (1982); Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

45. *See* Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CAL. L. REV. 29, 40-43 (1987) (discussing the question to what degree states can apply their corporate law code to pseudo-foreign corporations); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 57-61 (analyzing the limits placed on pseudo-foreign corporation laws by the commerce clause).

46. *See* CAL. CORP. CODE § 2115 (West 1990); N.Y. BUS. CORP. LAW § 1320 (McKinney 2003).

47. *See* Ebke, *supra* note 9, at 646 (pointing out that the debate about the constitutionality of

Despite these similarities in the legal frameworks of the United States and the European Community, it would be wrong to conclude that Community institutions should abstain from interfering. Unlike most U.S. states, the Member States of the European Community cannot generally be expected to refrain from trying to impose as much of their own corporation law on foreign corporations as possible. There are a number of determinative factors in this context. First, many Member States have traditionally adhered to the real seat doctrine[48] and may therefore decide to adopt pseudo-foreign corporation statutes simply to preserve the status quo. Second, and more importantly, the Member States of the European Community have far stronger incentives than U.S. states to adopt pseudo-foreign corporation statutes. This is due, in part, to the fact that some European corporate law regimes have generally placed great weight on protecting the interests of constituencies other than shareholders.[49] German law, for example, allows employees to be represented on the (supervisory) board and hence to influence the management of corporations.[50] Once corporations are granted free choice such rules are at particular risk of being avoided because they do not seek to maximize shareholder wealth. The Member States concerned may therefore rush to secure the application of the relevant rules via pseudo-foreign corporation statutes. Finally, as will be explained in more detail below, a European corporation's decision to reincorporate will usually mean that lawyers of the former state of incorporation lose the business and income provided by the corporation.[51] Member States may therefore be under considerable pressure from local attorneys to ensure the application of local corporate law by means of pseudo-foreign corporation statutes.

Given these factors, it is not entirely clear whether the Court's decisions in *Centros*, *Überseering*, and *Inspire Art* will suffice to completely prevent the application of local law to pseudo-foreign corporations. Rather, the Community institutions may have to intervene further in order to constrain the options of the Member States.

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pseudo-foreign corporation statutes is ongoing); Kozyris, *supra* note 44, at 60 (predicting that the constitutionality of section 2115 of the Corporation Law of California will be challenged again and may eventually reach the United States Supreme Court); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1053 n.95 (1991) (stressing that the constitutionality of California's pseudo-foreign corporation statute has not yet been resolved). State courts have occasionally applied local law to the internal affairs of pseudo-foreign corporations. *See* Lee Wilson v. La.-Pac. Res. Inc., 138 Cal. App. 3d 216, 219 (1982) (applying a California cumulative voting provision on a foreign corporation doing business in California). However, other decisions stress that the internal affairs doctrine is constitutionally mandated. *See* McDermott Inc. v. Lewis, 531 A.2d 206, 217 (Del. 1987) (noting that "application of the internal affairs doctrine is mandated by constitutional principles, except in 'the rarest situations'") (citation omitted).

48. *See supra* note 9.

49. ROMANO, GENIUS, *supra* note 7, at 129 (noting that most European nations take an enterprise approach to the corporation which requires the representation of employees as well as shareholders in corporate decision-making).

50. For a summary of the German rules on codetermination, see Jens C. Dammann, Note, *The Future of Codetermination After* Centros, 8 FORDHAM J. CORP. & FIN. L. 607, 618-22 (2003).

51. *See infra* text accompanying notes 221-223.

B. *Reincorporation*

In the United States, corporations are not only free to incorporate in a state other than the state where their real seat is located, but they can also change the applicable corporate law at any time by reincorporating elsewhere.[52] In the European Community, however, a corporation wishing to reincorporate in another Member State typically faces two obstacles, one in the area of corporate law, the other in the field of taxation.[53]

1. *Corporate Law*

As a matter of corporate law, reincorporation will only be feasible for a large number of corporations if it can be structured to avoid a one-by-one transfer of the corporation's assets and liabilities. To achieve that goal, the legal system can choose one of two approaches. First, it can allow corporations to perform an identity-preserving transfer of domicile, in which case the assets do not have to be transferred because the corporation remains the same legal person.[54] Alternatively, the legal system can allow corporations to reincorporate by means of a cross-border merger; a corporation is formed in the new state of incorporation, and the old corporation then merges with the new one. This second approach prevails in the United States.[55] In the European Community, by contrast, corporations will often find that neither of these two options is available.

a. *The Identity-Preserving Transfer of the Statutory Seat*

Consider, first, the possibility of an identity-preserving transfer of the corporation's statutory domicile. Obviously, such a transfer can only ensure free choice if corporations can transfer their statutory domicile without having to transfer their real seat as well. At present, however, Community law does not afford corporations that possibility and—as a rule—neither do the laws of the Member States.

The European Community has so far failed to resolve this problem by means of appropriate legislation.[56] Moreover, the right to reincorporate in

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52. That does not necessarily mean that reincorporation is possible at low cost. In fact, it is a matter of debate whether reincorporation is usually possible at low cost, or whether the relevant costs tend to be substantial even from the perspective of large, publicly-traded corporations. *Compare* ROMANO, GENIUS, *supra* note 7, at 34-45 (pointing out that the costs of reincorporation can be substantial) *and* Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 721 (1987) [hereinafter Romano, *The State Competition Debate*] (describing reincorporation as not costless) *with* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 586-89 (1990) (describing the costs of reincorporation as being relatively insignificant).

53. *See, e.g.*, Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 356 (2001) (with regard to German tax breaks).

54. That approach underlies the Proposed Fourteenth EC Company Law Directive, further discussed *infra* at note 56. *See* Sørensen & Neville, *supra* note 9, at 199 (describing the procedure for a nationality change under the said directive).

55. *See, e.g.*, Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1959 (1991).

56. In April 1997 the European Commission presented an internal proposal for a Fourteenth EC Company Law Directive, which it revised the same year. Commission Proposal for a Fourteenth

another Member State cannot be based on the Freedom of Establishment. In its famous *Daily Mail* decision from 1988, the Court of Justice explicitly held that "the Treaty regards . . . the question [of] whether . . . the registered office . . . of a company . . . may be transferred from one Member State to another as [a problem] which [is] not resolved by the rules concerning the right of establishment."[57]

That Community law does not give corporations the ability to transfer their statutory domicile from one state to another does not prevent the Member States from doing so, but both the old state of incorporation and the new state of incorporation must cooperate to achieve that aim.[58] The old state of incorporation has to allow the corporation to transfer its statutory seat without having to dissolve. The new state of incorporation has to accept the possibility that a foreign corporation can become a domestic one without being formed anew. Traditionally, the Member States of the European Community have shown little willingness to engage in such cooperation, especially when it comes to allowing domestic corporations to migrate elsewhere. Some Member States—including Germany,[59] the Netherlands,[60]

European Parliament and Council Directive on the Transfer of the Registered Office of a Company from One Member State to Another with a Change of Applicable Law, Zeitschrift für Wirtschaftsrecht [ZIP] 1721, 1721 (1997). A second proposal was advanced on November 11, 1997. Amended Commission Proposal for a Fourteenth European Parliament and Council Directive on the Transfer of the Registered Office of a Company from One Member State to Another with a Change of Applicable Law, http://www.uv.es/cde/TEXTOS/14thCLDd.pdf. Both proposals were intended to enable corporations to change their nationality without having to liquidate first. However, the relevant Directive has not yet been adopted. It should further be noted that the recently adopted Council Regulation on the Statute for a European Company (CR-SEC) does not resolve this problem. *See* Council Regulation 2157/2001 of 8 October 2001 on the Statute for a European company (SE), 2001 O.J. (L 294) 1, 1-21 [hereinafter CR-SEC]. The regulation in question has created an organizational form, the *Societas Europaea* or European Company, which is governed by Community law. *Id.* art. 9(1). At first glance, the CR-SEC may seem to offer a simple way to reincorporate in another Member State: Article 8(1) specifically grants the European Company the right to transfer its registered office to another Member State. Also, this provision explicitly provides that such a transfer shall not result in the winding up of the European Company or in the creation of a new legal person. Thus, a corporation wishing to transfer its office to another Member State could transform into a European Company. As such, it could then transfer its registered office to another Member State, only to transform into a corporation under the law of the new state of incorporation. However, Article 7 of the same regulation precludes such a course of action. That provision demands that the registered office be in the same state as the real seat. In other words, a corporation can only transfer its registered office if it also transfers its real seat.

57. Case 81/87, The Queen v. H.M. Treasury and Commissioners of Inland Revenue, *ex parte* Daily Mail and General Trust plc, 1988 E.C.R. 5483, para. 23, [1988] 3 C.M.L.R. 713, 726 (1988). Following *Centros*, some commentators questioned whether the holding in *Daily Mail* was still good law, suggesting that it had been silently overruled in *Centros*. *See, e.g.*, Robert Freitag, *Der Wettbewerb der Rechtsordnungen im Internationalen Gesellschaftsrecht* [*Regulatory Competition in International Corporate Law*], 10 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [EuZW] 267, 269 (1999); Otto Sandrock, Centros*: Ein Etappensieg für die Überlagerungstheorie* [Centros*: A Stage Victory for the Theory of Superimposement*], 54 BETRIEBSBERATER [BB] 1337, 1340 (1999). However, any such speculation must be regarded as refuted by *Überseering*. There, the Court explicitly distinguished the facts underlying *Überseering* from those forming the basis of the *Daily Mail* judgment. *See* Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919, para 66.

58. *See* Sørensen & Neville, *supra* note 9, at 191 (pointing out that a corporation can only make an identity-preserving nationality change if there is a legal basis for doing so in the national laws of the Member States concerned or in international agreements).

59. *See, e.g.*, BGHZ 29, 320 (328); OLG Hamm, NEUE JURISTISCHE WOCHENSCHRIFT-RECHTSPRECHUNGSREPORT [NJW-RR], 13 (1998), 615 (615); Großfeld, *supra* note 9, at 63.

60. *See, e.g.*, Levinus Timmerman, *Sitzverlegung von Kapitalgesellschaften nach niederländischem Recht und die 14. EU-Richlinie* [*The Transfer of the Corporate Seat under Dutch Law*

the United Kingdom,[61] and Ireland[62]—simply do not allow corporations to transfer their statutory domicile into another Member State while retaining their legal personality. Spain,[63] Portugal,[64] Belgium,[65] and Luxembourg,[66] will allow a corporation to transfer its statutory domicile, but only if the corporation transfers its real seat as well. Italy allows corporations to transfer their statutory seat to another Member State, while retaining their real seat in Italy.[67] It is a matter of much debate, however, whether such transfers allow Italian corporations to escape the application of Italian law.[68]

b. *Transnational Mergers*

In light of these limitations, one might think of adopting the U.S. approach to reincorporation, according to which corporations reincorporate by merging with newly-formed corporations in the desired state of incorporation. However, that path also proves difficult. Community law itself does not guarantee the possibility of transnational mergers,[69] but this does not prevent the Member States from allowing cross-border mergers that do not require transfers of the corporation's real seat. However, when it comes to the willingness of the Member States to take this course of action, the picture is mixed. Some states such as Germany[70] and Austria[71] do not allow their

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and the 14th Directive], 28 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 147, 152-53 (1999).

61. *See, e.g.*, Todd v. Egyptian Delta Land & Investment Co., [1928] 1 K.B. 152, 173; Gasque v. I.R.C., [1940] 2 K.B. 80, 84; Carl Zeiss Stiftung v. Rayner & Keeler & others (No. 3), [1970] 1 Ch. 506, 544; J.G. COLLIER, CONFLICT OF LAWS 61 (2d ed. 1994); DICEY AND MORRIS ON THE CONFLICT OF LAWS 1104 (Lawrence Collins et al. eds., 12th ed. 1993); ALBERT FARNSWORTH, THE RESIDENCE AND DOMICIL OF CORPORATIONS 230 (1939); P.M. NORTH & J.J. FAWCETT, CHESHIRE & NORTH'S PRIVATE INTERNATIONAL LAW 174 (12th ed. 1992).

62. *See, e.g.*, PAUL EGAN, IRISH CORPORATE PROCEDURES 10 (1993); RONAN KEANE, COMPANY LAW IN THE REPUBLIC OF IRELAND 99-100 (2d ed. 1991).

63. *See* AXEL STEIGER, GRENZÜBERSCHREITENDE FUSION UND SITZVERLEGUNG VON KAPITALGESELLSCHAFTEN INNERHALB DER EU NACH SPANISCHEM UND PORTUGIESISCHEM RECHT [CROSS-BORDER MERGERS AND TRANSFERS OF DOMICILE WITHIN THE EU UNDER SPANISH AND PORTUGUESE LAW] 189, 274 (1997).

64. *See id.* at 268, 275.

65. *See* Eddy Wymeersch, *Die Sitzverlegung nach belgischem Recht* [*The Transfer of the Seat Under Belgian Law*], 28 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 126, 136-38 (1999).

66. *See* Peter Behrens, *Identitätswahrende Sitzverlegung einer Kapitalgesellschaft von Luxemburg in die Bundesrepublik Deutschland* [The Identity-Preserving Transfer of the Corporate Seat from Luxembourg to the Federal Republic of Germany], 32 RECHT DER INTERNATIONALEN WIRTSCHAFT [R.I.W.] 590 (1986).

67. *See* HEIKE BRUHN, NIEDERLASSUNGSFREUNDLICHE SITZVERLEGUNG UND VERSCHMELZUNG ÜBER DIE GRENZE NACH ITALIENISCHEM RECHT [THE ESTABLISHMENT-FRIENDLY TRANSFER OF THE SEAT AND THE CROSS-BORDER MERGER UNDER ITALIAN LAW] 192-94 (2002).

68. *See id.* at 198-217.

69. A limited exception to this rule concerns the European Company. *See supra* note 56. Under the relevant regulation, two corporations from different Member States can merge into a European Company. *See* CR-SEC, *supra* note 55, art. 2(1). However, as mentioned before, the statutory domicile of the European Company has to end up in the state where the organization's real seat is located. *Id.* art. 7(1). Hence, merger possibilities under the European Company Statute would not create free choice.

70. *See, e.g.*, Georg Maier-Reimer, *in* UMWANDLUNGSGESETZ § 120, at 1216 margin no. 19 (Johannes Semler & Arndt Stengel eds., 2003). *But see* Marcus Lutter, *Umstrukturierung von Unternehmen über die Grenze: Versuch eines Resümees* [*Cross-Border Corporate Restructuring: Attempt at a Summary*], 23 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 87, 91

domestic corporations to merge with foreign corporations. Other Member States—including Spain,[72] France,[73] the United Kingdom,[74] Ireland,[75] Portugal,[76] and Italy[77]—allow such mergers. However, even in Member States where cross-border mergers are theoretically possibility, the legal situation is frequently fraught with uncertainty.[78] Cross-border mergers, therefore, have generally had little practical significance in Europe.[79]

2. *Taxation*

A second obstacle to reincorporation arises in the field of taxation. A significant degree of corporate mobility can only be achieved where corporations can transfer their statutory domicile without having their hidden reserves taxed.[80] Due to generous tax accounting rules, the value of a corporation's assets for tax accounting purposes can be much lower than the market value. If a corporation is suddenly forced to disclose its hidden reserves—that is, if the corporation is compelled to value all of its assets at their market value—the result may be a surge in the corporation's taxable income.

In the past, European corporations often could not avoid this consequence if they wanted to reincorporate.[81] However, this problem has

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(1994) (suggesting with a view to the Freedom of Establishment that German law should be interpreted in such a way as to allow cross-border mergers).

71. *See, e.g.*, RATKA, GRENZÜBER SITZVERLEGUNG VON GESELLSCHAFTEN 223 (2002) (pointing out that the Austrian Stock Corporations Act does not explicitly mention cross-border mergers and that the dominant view considers such mergers to be illegal).

72. *See* STEIGER, *supra* note 63, at 82.

73. *See* ANDREA REIK, GRENZÜBERSCHREITENDE RESTRUKTURIERUNG VON UNTERNEHMEN: EINE BILATERALE UNTERSUCHUNG ZWISCHEN DEUTSCHLAND UND FRANKREICH [CROSS-BORDER RESTRUCTURING OF ENTERPRISES: A BILATERAL ANALYSIS OF GERMANY AND FRANCE] 266 (2001) (noting that under the prevailing view in the French legal literature, French law allows cross-border mergers in both directions).

74. *See* FREDERICK GILLESSEN, EUROPÄISCHE TRANSNATIONALE SITZVERLEGUNG UND FUSION IM VEREINIGTEN KÖNIGREICH UND IN IRELAND [EUROPEAN CROSS-BORDER TRANSFERS OF THE CORPORATE DOMICIL AND MERGERS IN THE UNITED KINGDOM AND IN IRELAND] 385 (2000).

75. Irish statutory law does not explicitly provide for the possibility of a transnátional merger. *See* GILLESSEN, *supra* note 74, at 435-436. However, it has been suggested that such a merger may be possible anyway. *See id.* at 436-437 (suggesting an analogous application of the Merger Regulation on cross-border mergers).

76. *See* STEIGER, *supra* note 63, at 215.

77. *See* BRUHN, *supra* note 67, at 266-267 (pointing out that the legality of cross-border mergers under Italian law is beyond doubt).

78. For example, in the United Kingdom, there seems to be no case law dealing with this issue. *See* GILLESSEN, *supra* note 74, at 385. Similarly, it has been suggested that the Spanish and Portuguese rules on cross-border mergers may be so fraught with uncertainty as to preclude such mergers in practice. *See* STEIGER, *supra* note 63, at 274.

79. *See* KIENINGER, WETTBEWERB, *supra* note 18, at 165; Marcus Lutter, *First Steps for a European Law on Corporate Groups*, 36 COMMON MKT. L. REV. 1, 1 (1999).

80. The regulation concerning the European Company does not remove this problem either. In fact, the regulation's preamble makes it clear that the regulation does not govern matters of taxation at all. *See* CR-SEC, *supra* note 56, pmbl. para. 20 ("This Regulation does not cover other areas of law such as taxation, competition, intellectual property or insolvency. The provisions of the Member States' law and of Community law are therefore applicable in the above areas and in other areas not covered by this Regulation.").

81. For example, under German law, any change in nationality will be treated as a liquidation of the company. *See* §§ 11, 12 Körperschaftssteuergesetz 2002 (KStG 2002) [Corporate Income Tax Act], v. 15.10.2002 (BGBl. I S.4144). *See also* OTTO H. JACOBS, INTERNATIONALE

now been solved at least in part by Community law. Under a directive adopted in 1990, Member States are prohibited from taxing a corporation's hidden reserves in the case of transnational merger.[82] Of course, that privilege proves useless to the extent that corporations find it either impossible or impractical to undertake such mergers.[83]

3. *Conclusions on Reincorporation*

Because Member States have failed to cooperate independently to facilitate reincorporation, Community law must intervene. Given the existing rules on the taxation of cross-border mergers,[84] the simplest way to achieve this aim would be to require the Member States to allow cross-border mergers.[85] As a general matter, it is not desirable that Community law regulate the details of such mergers, if only because the differences between the various national corporate governance regimes stand in the way of a Community rule that would be optimal for corporations in all Member States. Nevertheless, Member States must, of course, be prevented from circumventing Community legislation. Accordingly, the Member States should be prohibited from defining the requirements for mergers in a way that cannot reasonably be justified by the need to protect (minority) shareholders, creditors or—in Member States imposing rules on worker codetermination[86]—employees. It should be noted in this context that rules protecting the interests of workers do not prevent corporations from choosing the most efficient corporate law regime as long as the corporation and its workers can enter into bargains under which some efficiency gains are distributed to the corporation's employees in exchange for their willingness to forego the right to participate in the corporation's management. Instead of prohibiting the Member States from safeguarding the interests of workers, EC law should simply require the Member States to allow these kinds of Coasean bargains.

UNTERNEHMENSBESTEUERUNG [INTERNATIONAL TAXATION OF CORPORATIONS] 1018 (1999) (stressing that the taxation of hidden assets presents an obstacle for corporations intending to reincorporate abroad).

82. *See* Council Directive 90/434/EEC of 23 July 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, art. 4 (1), 1990 O.J. (L 225) 1, 2 ("A merger or division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes.").

83. The regulation concerning the European Company does not remove this problem either. In fact, the regulation's preamble makes it clear that the regulation does not govern matters of taxation at all. *See* CR-SEC, *supra* note 56, pmbl. 20 (stating that "[t]his Regulation does not cover other areas of law such as taxation").

84. *See supra* text accompanying notes 79-83.

85. *See supra* text accompanying notes 69-83.

86. Worker codetermination is the participation of employee representatives in the management of corporations.

C. *The Need To Litigate in the State of Incorporation*

Another significant obstacle to free choice lies in the fact that once a corporation is incorporated in a certain Member State, it may have to litigate some of its internal and external affairs in that state.[87] As a result, corporations may choose to incorporate in the real seat state, even though they find another state's corporate law more efficient. This claim may be somewhat surprising from the U.S. perspective. After all, U.S. corporations also face jurisdictional consequences when they incorporate in another state.[88] Although exposure to litigation in the state of incorporation is sometimes mentioned as a factor that may deter closely held corporations from reincorporating,[89] it is not usually recognized as preventing publicly held corporations from choosing the state law they find most efficient. In Europe, however, the situation is different for three reasons. First, due to certain practical circumstances, litigation in another Member State will often be more burdensome in Europe than it is across state lines in the United States. Second, European corporations are exposed to litigation in the state of incorporation to a substantially greater extent than corporations in the United States. Third, there are a number of practical reasons why European corporations may find it unavoidable to litigate in the state of incorporation, even if the law does not compel them to do so. Each of these reasons will be explained in turn.

1. *The Need To Litigate in the State of Incorporation as a Burden*

European corporations will find it more difficult to litigate in the state of incorporation for at least two reasons. First, there are language barriers to be considered. As long as the state of incorporation and the real seat state have different languages, litigating abroad will often prove extremely costly and tedious. Next, there is the problem of bias. In both the United States and in Europe, a pseudo-foreign corporation being sued in the state of incorporation may fear that the sympathies of judges and juries are not stacked in its favor. After all, the plaintiff may be a local resident, whereas the corporation only

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87. This problem has not gone unnoticed in the European legal literature. Eva-Maria Kieninger notes that European corporations may be deterred from incorporating in another Member State, because they would have to litigate certain internal affairs in that state. KIENINGER, WETTBEWERB, *supra* note 18, at 173. Strangely, though, Kieninger does not mention the far more significant risk of having to litigate external affairs in the state of incorporation. Nor does she deal with practical constraints to litigate in the state of incorporation.

88. As a general rule, U.S. states exert jurisdiction over all suits brought against domestic corporations.

89. The risk of exposure to litigation in the state of incorporation is sometimes mentioned as a reason why close corporations choose not to incorporate in another Member State. As Professor Ian Ayres has noted,

> If the foreign state is geographically distant from the corporation's base of operations, the possibility of more expensive litigation might significantly raise the expected cost of foreign incorporation. This potential expense might not deter a closely held Philadelphia company from incorporating in Delaware, but might substantially chill the similar interest of a small Chicago business.

Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 375 (1992) [hereinafter Ayres, *Judging Close Corporations*].

has a formal connection with the state of incorporation.[90] Despite this common point of departure, the bias against corporations that have their real seat in another state is likely to be stronger in Europe. In the United States, citizens of one state may not always identify completely with the interests of citizens from other states,[91] but the relevant gap is far greater in Europe, where different Member States are separated by political, linguistic, and cultural barriers. In sum, therefore, European corporations will generally be more reluctant than their U.S. counterparts to litigate in the state of incorporation when the latter diverges from the real seat state.

2. *Legal Factors that Compel the Corporation To Litigate in the State of Incorporation*

Next, consider the extent to which the law forces corporations to litigate in the state of incorporation. A corporation can be compelled to litigate in its state of incorporation both with regard to internal and with regard to external affairs.

a. *Internal Affairs*

The need to litigate internal affairs[92] in the courts of the state of incorporation will usually not be too burdensome, at least where large public corporations are concerned. Indeed, as the case of Delaware suggests, corporations may well choose to incorporate in a particular state, precisely because they seek access to that state's courts. The quality of Delaware's courts is generally portrayed as an important[93] or even as the single most important[94] reason for reincorporating in Delaware.[95] Nevertheless, at least

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90. Its business is operated in the real seat state, and its owners are most likely to be found either in the real seat state or distributed across many states.

91. Some scholars have doubted the significance of regional bias in the United States. *See, e.g.*, RICHARD A. POSNER, THE FEDERAL COURTS: CRISIS AND REFORM 142-43 (1985) (claiming that local bias is not an important factor motivating the use of diversity jurisdiction); Henry J. Friendly, *The Historic Basis of Diversity Jurisdiction*, 41 HARV. L. REV. 483, 510 (1928) (arguing that the creation of diversity jurisdiction was motivated by fear of "local hostilities, which had only a speculative existence in 1789, and are still less real today"). However, empirical studies tend to confirm that fear of such bias is a reality. *See, e.g.*, Jerry Goldman & Kenneth S. Marks, *Diversity Jurisdiction and Local Bias: A Preliminary Empirical Inquiry*, 9 J. LEGAL STUD. 93, 102 (1980) (stating that survey research in the Northern District of Illinois revealed significant fears among attorneys that their clients might suffer from local bias in state court); Note, *The Choice Between State and Federal Court in Diversity Cases in Virginia*, 51 VA. L. REV. 178, 182 (1965) (stating that a survey in Virginia revealed the fear of bias as an important reason for the use of diversity jurisdiction). *See also* Aetna Cas. & Sur. Ins. Co. v. Greene, 606 F.2d 123, 127 (6th Cir. 1979) (pointing out the possibility of local bias against an out-of-state insurance agency); William A. Braverman, Note, *Janus Was Not a God of Justice: Realignment of Parties in Diversity Jurisdiction*, 68 N.Y.U. L. REV. 1072, 1086 (1993) (stating that the purpose of diversity jurisdiction—to protect the parties against local bias—is not obsolete).

92. *See supra* note 1.

93. Romano, *The State Competition Debate*, *supra* note 52, at 724.

94. Black, *supra* note 52, at 589-590 (pointing to Delaware's judges as the primary reason for Delaware's success in the market for corporate charters and citing quick judicial decisions as an additional factor).

95. Corroborating this view are studies according to which parties having the choice between Delaware courts and other (federal or state) courts generally tend to litigate in Delaware. *See* ROMANO, GENIUS, *supra* note 7, at 41 (analyzing empirical data that demonstrate the popularity of the Delaware

small and medium-sized businesses will often want to avoid litigating their internal affairs in the state of incorporation. It is important to note, therefore, that in the United States, corporations have a good chance of being able to do so. To be sure, no constitutional bar prevents the state of incorporation from exercising jurisdiction over the internal affairs of domestic corporations. U.S. states are free to define the extent of their own jurisdiction[96] as long as they respect constitutionally-mandated minimum contact requirements.[97] A corporation's decision to incorporate in a particular state is generally considered sufficient to meet that requirement.[98] However, the vast majority of states uphold so-called "outbound" forum selection clauses—as long as they are reasonable—by which the parties agree to submit to a given jurisdiction outside that state.[99] As a result, a corporation wishing to avoid litigating its internal affairs in the state of incorporation could simply include a choice of forum clause to this effect in its articles of incorporation, arguing that this meets the reasonableness standard.

Chancery Court as a forum for litigation); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 495-96 (1987) (claiming that "an impressionistic glance at important corporate law cases over the past few years suggests that a substantial proportion of such cases—and presumably less important cases as well—are brought in Delaware").

96. The Supreme Court has noted:

> It is the right of every State to establish such courts as it sees fit, and to prescribe their several jurisdictions as to territorial extent, subject-matter and amount, and the finality and effect of their decisions, provided it does not encroach upon the proper jurisdiction of the United States, and does not abridge the privileges and immunities of citizens of the United States, and does not deprive any person of his rights without due process of law, nor deny to any person the equal protection of the laws, including the equal right to resort to the appropriate courts for redress.

Missouri v. Lewis, 101 U.S. 22, 30 (1879).

97. *See, e.g.*, Kulko v. Superior Court, 436 U.S. 84, 91 (1978) (requiring "a sufficient connection between the defendant and the forum State").

98. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 41 (1971) ("A state has power to exercise judicial jurisdiction over a domestic corporation.").

99. Volkswagenwerk, A.G. v. Klippan, GmbH, 611 P.2d 498, 503 (Alaska 1980), *cert. denied*, 449 U.S. 974 (1980); Societe Jean Nicolas et Fils v. Mousseux, 59 P.2d 541, 542 (Ariz. 1979); SD Leasing, Inc. v. Al Spain & Assocs., Inc., 640 S.W.2d 451, 452 (Ark. 1982); Smith, Valentino & Smith, Inc. v. Superior Court of L.A. County, 551 P.2d 1206, 1208 (Cal. 1976); ABC Mobile Sys., Inc. v. Harvey, 701 P.2d 137, 139 (Colo. Ct. App. 1985); Funding Sys. Leasing Corp. v. Diaz, 378 A.2d 108, 109 (Conn. C.P. 1977); Elia Corp. v. Paul N. Howard Co., 391 A.2d 214, 216 (Del. Super. Ct. 1978); Manrique v. Fabbri, 493 So. 2d 437, 440 (Fla. 1986); Calanca v. D & S Mfg. Co., 510 N.E.2d 21, 23 (Ill. App. Ct. 1987); Prudential Res. Corp. v. Plunkett, 583 S.W.2d 97, 99 (Ky. Ct. App. 1979); Hauenstein & Bermeister, Inc. v. Met-Fab Indus., Inc., 320 N.W.2d 886, 890 (Minn. 1982); High Life Sales Co. v. Brown-Forman Corp., 823 S.W.2d 493, 497 (Mo. 1992); Air Econ. Corp. v. Aero-Flow Dynamics, Inc., 300 A.2d 856, 856 (N.J. 1973); Credit Francais Int'l, S.A. v. Sociedad Financiera de Comercio, C.A., 490 N.Y.S.2d 670, 674 (N.Y.App.Div. 1985); United Standard Mgmt. Corp. v. Mahoning Valley Solar Res., Inc., 476 N.E.2d 724, 726 (Ohio Ct. App. 1984); Reeves v. Chem. Indus. Co., 495 P.2d 729, 732 (Or. 1972); St. John's Episcopal Mission Ctr. v. S.C. Dep't of Soc. Serv., 280 S.E.2d 207, 207 (S.C. 1981); Green v. Clinic Masters, Inc., 272 N.W.2d 813, 815 (S.D. 1978); Int'l Collection Serv., Inc. v. Gibbs, 510 A.2d 1325, 1327 (Vt. 1986). *See also* Cerami-Kote, Inc. v. Energywave Corp., 773 P.2d 1143, 1146-47 (Idaho 1989) (holding a forum selection clause to be invalid under Idaho statutory law); Davenport Mach. & Foundry Co. v. Adolph Coors Co., 314 N.W.2d 432, 437 (Iowa 1982) (holding that "under a motion to dismiss an Iowa action without prejudice on the ground of forum non conveniens, such a clause, if otherwise fair, will be given consideration *along with the other factors presented*, in determining whether the Iowa court should decline to entertain the suit") (emphasis added); State *ex rel.* Polaris Indus., Inc. v. Dist. Court, 695 P.2d 471, 471 (Mont. 1985) (holding forum selection clauses to be void under Montana statutory law).

In the same way, a corporation can minimize the risk of having to litigate in a federal court sitting in the state of incorporation. The Supreme Court has held that forum selection clauses are governed by federal rather than by state law even in cases of diversity jurisdiction.[100] Under federal law, however, forum selection clauses are generally regarded as valid[101] and therefore have to be given due consideration when a motion to transfer under 28 U.S.C. § 1404(a) is made.[102] While 28 U.S.C. § 1404(a) calls for a weighing of various case-specific factors,[103] a forum selection clause is thought to be a "significant factor that figures centrally in the district court's calculus."[104]

In the European Community, by contrast, the situation looks different. Here, the allocation of jurisdiction is governed by the Council Regulation 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters (CR-JREJ).[105] As a general matter, Article 23(1) of this regulation allows the parties to choose a forum state by mutual agreement.[106] However, with regard to a corporation's internal affairs, Article 22(2) contains an important exception to that general rule. Provided that the Member States apply the state of incorporation doctrine, certain internal matters—including the dissolution of the corporation and the validity of the decisions of its organs—must be litigated in the courts of the state of incorporation.[107] Moreover, this rule is mandatory.[108] For the reasons described above, it is not difficult to see that the existence of Article 22(2) may discourage at least some European corporations from incorporating in the state whose corporate law they find most efficient. Thus, in order to

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100. Stewart Org., Inc. v. Ricoh Corp., 487 U.S. 22, 27 (1988).

101. *See* The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 10, 15 (1972) (holding, in an admiralty case, that forum selection clauses are prima facie valid and that they should be enforced unless the resisting party can "clearly show that enforcement would be unreasonable and unjust, or that the clause was invalid for such reasons as fraud or overreaching . . . [or that] enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision"); *In re* Fireman's Fund Ins. Cos., 588 F.2d 93, 95 (5th Cir. 1979) (pointing out that where parties have selected a forum by contract, it is incumbent upon the party resisting to establish that the choice was unreasonable, unfair, or unjust); Leasing Serv. Corp. v. Broetje, 545 F. Supp. 362, 369 (S.D.N.Y. 1982) (holding that forum selection clauses and contracts are "generally enforced unless defendants can 'show that enforcement would be unreasonable and unjust, or that clause was invalid for such reasons as fraud or overreaching'").

102. *Stewart Org., Inc.*, 487 U.S. at 29.

103. 28 U.S.C. § 1404(a) (2004); *see also Stewart Org., Inc.*, 487 U.S. at 29.

104. *Stewart Org., Inc.*, 487 U.S. at 29.

105. Council Regulation 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, 2001 O.J. (L 12) 1, 1-23 [hereinafter CR-JREJ].

106. *Id.* art. 23(1) ("If the parties . . . have agreed that . . . the courts of a Member State are to have jurisdiction . . . those courts shall have jurisdiction. Such jurisdiction shall be exclusive . . . .").

107. *Id.* art 22(1) (stating that these matters have to be litigated in the Member State where the corporation's "seat" is located.) Of course, this wording leads to the question of whether the real seat or the statutory seat is to be decisive. Article 22(2) answers that question by stipulating that the courts shall apply their own national rules of private international law to determine the seat of a corporation. According to the state of incorporation doctrine, however, a corporation's "seat" is understood to be its statutory seat.

108. *Id.* art. 23(5) ("Agreements . . . conferring jurisdiction shall have no legal force . . . if the courts whose jurisdiction they purport to exclude have exclusive jurisdiction by virtue of Article 22.")

remove this obstacle to free choice, the competent Community institutions must eliminate Article 22(2).

b. *External Affairs*

With regard to external affairs, the extent of exposure to litigation in the state of incorporation is also greater in the European Community than it is in the United States. To be sure, the point of departure is rather similar: U.S. states can—and in the absence of a forum selection clause providing for another forum, routinely do—exercise jurisdiction over all suits brought against domestic corporations.[109] The same is true in the European Community. According to CR-JREJ Article 2(1), persons domiciled in a Member State shall be sued in the courts of that Member State.[110] Article 60(1)(a) makes clear that a corporation is not only domiciled in the Member State where its central administration or principal place of business can be found, but also in the Member State where its statutory seat is located.[111] A further parallel between U.S. law and Community law lies in the fact that corporations can avoid being sued in their state of incorporation by means of a forum selection clause.[112]

However, a crucial difference remains. Under U.S. law, the risk of exposure to litigation in the state of incorporation is limited to some degree by the doctrine of forum non conveniens. Under that doctrine, which most states recognize in one form or another,[113] a court may decline to exercise jurisdiction if it considers itself an unsuitable forum.[114] In making this decision, the court will typically balance various factors, including access to evidence, the desirability of trial by jury in the locality of the relevant events, the domiciles of the parties, and the difficulty of applying unfamiliar law.[115]

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109. *See, e.g.*, DEL. CODE. ANN. tit. 10, § 3111 (2003).

110. CR-JREJ, *supra* note 105, art. 2(1) ("Subject to this Regulation, persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State.").

111. *Id.* art. 60 (1) ("For the purposes of this Regulation, a company or other legal person or association of natural or legal persons is domiciled at the place where it has its: (a) statutory seat, or (b) central administration, or (c) principal place of business.").

112. *See supra* note 99 and accompanying text (discussing U.S. law); CR-JREJ, *supra* note 105, art. 23(1) ("If the parties, one or more of whom is domiciled in a Member State, have agreed that a court or the courts of a Member State are to have jurisdiction . . . that court or those courts shall have jurisdiction. Such jurisdiction shall be exclusive unless the parties have agreed otherwise.").

113. *See, e.g.*, Stangvik v. Shiley, Inc., 819 P.2d 14, 17-18 (Cal. 1991); Union Carbide Corp. v. Aetna, Cas. & Sur., Co., 562 A.2d 15, 17 (Conn. 1989); Parvin v. Kaufmann, 236 A.2d 425, 427 (Del. 1967); Bland v. Norfolk & W. Ry., 506 N.E.2d 1291, 1293-1294 (Ill. 1987); MacLeod v. MacLeod, 383 A.2d 39, 41-43 (Me. 1978); Varkonyi v. S.A. Empresa de Viacao A.R.G., 239 N.E.2d 542, 544 (N.Y. 1968); Chambers v. Merrell-Dow Pharm., 519 N.E.2d 370, 372-373 (Ohio 1988); Zurick v. Inman, 426 S.W.2d 767, 768-772 (Tenn. 1968). In some states, the doctrine of forum non conveniens has by now become part of statutory law. *See, e.g.*, ALA. CODE § 6-5-430 (1993); LA. CODE CIV. PROC. ANN. art. 123 (West 1997); N.Y. C.P.L.R. 327 (McKinney 1990); 42 PA. CONS. STAT. ANN. § 5322(e) (West 1981); TEX. CIV. PRAC. & REM. CODE ANN. § 15.002(b) (Vernon 2002). *But see* Young Lee, Note, *Forum Selection Clauses: Problems of Enforcement in Diversity Cases and State Courts*, 35 COLUM. J. TRANSNAT'L L. 663, 685 (1997) (noting that some states do not seem to recognize a forum non conveniens doctrine). *See also* Harry S. Peterson Co. v. Nat'l Union Fire Ins. Co., 434 S.E.2d 778, 783 (Ga. Ct. App. 1993) (rejecting the forum non conveniens doctrine).

114. *See* Gulf Oil Corp. v. Gilbert, 330 U.S. 501, 508-09 (1947).

115. In *Gulf Oil Corp.*, the Supreme Court noted:

If the combination and weight of factors requisite to given results are difficult to forecast

At the federal level, the function of the forum non conveniens doctrine is fulfilled by 28 U.S.C. § 1404(a).[116] Under that provision a district court, for the convenience of parties and witnesses, may transfer any civil action to any other district where it might have been brought.[117] By contrast, there is no European equivalent to the doctrine of forum non conveniens in the CR-JREJ.[118]

While this jurisdictional framework represents a significant obstacle to free choice in the European Community, it is once again easy to see how this obstacle can be removed: eliminate CR-JREJ Article 60(1)(a), which provides that the site of the corporation's statutory seat is one of the places where the corporation is domiciled.

3. *Practical Factors that Compel the Corporation To Litigate in the State of Incorporation*

Another factor forcing corporations to litigate their internal affairs in the state of incorporation may be the friction that can exist between the corporate law of the state of incorporation and the judicial system of the real seat state. In other words, the judicial system of the real seat state may not be suited for the implementation of the *lex incorporationis*, forcing pseudo-foreign corporations to litigate their internal affairs elsewhere.

First, one should note that this problem is more limited than it may appear at first glance. In particular, there is no reason to fear that every conflict between the procedural law of the real seat state and the substantive law of the state of incorporation will be a burden on pseudo-foreign corporations attempting to litigate their internal affairs in the courts of the former. That is because there is no need to limit the state of incorporation doctrine and hence the application of the *lex incorporationis* to substantive corporate law. Indeed, in the United States as in other countries, there is a broad consensus that a merely formal distinction between procedural and

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> or state, those to be considered are not difficult to name. An interest to be considered, and the one likely to be most pressed, is the private interest of the litigant. Important considerations are the relative ease of access to sources of proof; availability of compulsory process for attendance of unwilling, and the cost of obtaining attendance of willing, witnesses; possibility of view of premises, if view would be appropriate to the action; and all other practical problems that make trial of a case easy, expeditious and inexpensive. There may also be questions as to the enforceability of a judgment if one is obtained.

Id. In Delaware, a similar test is used. *See* Gen. Foods Corp. v. Cryo-Maid, Inc., 198 A.2d 681, 684 (Del. 1964) (listing various factors to be considered).

116. 28 U.S.C. § 1404(a) (2004).

117. § 1404(a) was designed as an attempt to statutorily embody and modify the doctrine of forum non conveniens. *See* A.J. Indus., Inc. v United States Dist. Court for Cent. Dist., 503 F.2d 384, 386 (9th Cir. 1974). The very purpose of this provision is to permit courts to grant transfers upon a lesser showing of inconvenience than that which is required under that doctrine. *See* Norwood v. Kirkpatrick, 349 U.S. 29, 32 (1955).

118. *See, e.g.*, Martine Stückelberg, *Lis Pendens and Forum Non Conveniens at the Hague Conference*, 26 BROOK. J. INT'L L. 949, 962-964 (2001) (noting that the Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matter did not include a forum non conveniens doctrine). In 2001, the relevant convention was replaced by the CR-JREJ, *supra* note 105. However, there is no indication that the CR-JREJ, the text of which is largely identical to that of the aforementioned convention, can be interpreted to leave room for the forum non conveniens doctrine.

substantive law should not be decisive in determining the scope of application of the *lex incorporationis*.[119] Rather, the law of the state of incorporation is frequently applied to "procedural" as well as to "substantive" questions, especially where that law shapes the rights and liabilities of the parties. To give just one example, the Revised Model Business Corporation Act specifically provides that shareholder derivative suits are—subject to certain limitations—governed by the law of the state of incorporation rather than that of the forum state.[120] That said, at least three problems are likely to arise.

a. *The Expertise of Courts*

The most obvious problem concerns the legal expertise of the judges in the real seat state. Judges will generally be more familiar with their own state's law than with the law of the state of incorporation. As a result, the outcome of proceedings brought in the real seat state may be far less predictable than that of proceedings brought in the state of incorporation. Moreover, the need to ascertain the law of the state of incorporation will often cause delays that the parties can prevent by litigating in the state of incorporation. To be sure, both issues exist in the United States as well as in the European Community. They can, however, be expected to be far more severe in the European context. Both language barriers and fundamental differences between the various legal regimes are bound to make the correct application of foreign corporate law more difficult for European judges than for their U.S. counterparts.

b. *The Time Factor*

Another problem concerns the timeliness with which justice is rendered in the various Member States. For many reasons, the duration of civil proceedings in the European Community varies greatly from Member State to Member State.[121] This fact is crucial, because the quality of a state's court

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119. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 122 cmt. b (1971) (pointing out that the Restatement avoids classifying issues as "procedural" or "substantive," because courts might be misled into "unthinking adherence" to precedents that classify a given issue as procedural or substantive).

120. *See* REV. MODEL BUS. CORP. ACT § 7.47 (1998) ("In any derivative proceeding in the right of a foreign corporation, the matters covered by this subchapter shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation except for sections 7.43, 7.45 and 7.46."). *See also* Kozyris, *supra* note 45, at 21-26 (assessing existing case law regarding the application of the lex incorporationis to derivative actions). This corresponds to the principle recognized in German law that the question of who may enforce corporate norms by bringing suit is governed by the law of the state whose corporate law applies *See, e.g.*, DANIEL ZIMMER, INTERNATIONALES GESELLSCHAFTSRECHT [CONFLICT OF LAWS IN CORPORATE MATTERS] 124 (1996); Großfeld, *supra* note 9, at 85.

121. The differences regarding the average duration of legal proceedings in Germany and Italy serve to illustrate this point. In Germany, the judiciary basically consists of four levels: the Amtsgericht (Lower Court), the Landgericht (Intermediate Court), the Oberlandesgericht (Court of Appeals), and the Bundesgerichtshof (Supreme Court). Depending on the amount in controversy, legal proceedings are either commenced before the Amtsgericht or before the Landgericht. The parties can usually appeal at least once, namely to the court at the next level. In certain cases, a second appeal is possible. In 2000, the average duration of a civil proceeding before the Amtsgericht was 4.3 months. The average duration of a civil proceeding before the Landgericht was 6.9 months in those cases where the intermediate federal court functioned as a court of first instance and 5.5 months in those cases where the Landgericht

system is not without importance for the shape of that state's corporate law. Corporate law regimes can either rely strongly on litigation as a means to enforce corporate norms or can minimize the need for an efficient court system.[122] Obviously, states with an inefficient court system will find it efficient to compensate for that institutional weakness by taking the latter approach. This interdependence between a state's corporate law and its court system may well limit the ability of pseudo-foreign corporations to litigate their internal affairs in the real seat state; the court system of the real seat state may not be suited for the implementation of the *lex incorporationis*. The situation in Italy illustrates this point. In 1998, the average duration of civil proceedings (*cognizione ordinaria*) ranged from 2.13 to 4.46 years depending on the type of court in which the action was brought.[123] It is unsurprising, therefore, that preliminary injunctions aside, the reliance on courts in Italian corporate governance is far less pronounced than in other countries.[124] In particular, derivative suits, while technically possible, do not play any role in practice.[125] Obviously, a corporation formed under a corporate law regime that relies more strongly on shareholder litigation will be reluctant to use Italy as a forum for litigating its internal affairs.

c. *Contingent Fee Arrangements*

Yet another problem is posed by differing state rules concerning contingent fee arrangements. That the real state's rules on contingent fee arrangement can adversely affect the functioning of the state of incorporation's corporate law is fairly obvious. As has often been noted,

functioned as a court of appeals. The average duration of a proceeding before the Oberlandesgericht was 8.4 months. BUNDEMINISTERIUM DER JUSTIZ, ZAHLEN AUS DER JUSTIZ 6-7 (2003), http://www.bmj.bund.de/images/11721.pdf. As regards the length of civil proceedings before the Bundesgerichtshof, the situation was as follows: 6% of cases were decided within three months, and an additional 63.1% were decided within twelve months. *See* BUNDESGERICHTSHOF, TÄTIGKEITSBERICHT 2000, ARBEITSBELASTUNG DES BUNDESGERICHTSHOFS IM JAHR 2002, PRESSEGESPRÄCH AM 27. JANUAR 2003, http://www.bundesgerichtshof.de/presse/taetigkeitsberichte/taetigkeit20002.php. The German situation differs considerably from that in Italy, as revealed by data regarding the duration of civil proceedings (*cognizione ordinaria*) in Italy in 1998. In Italy, civil proceedings can be initiated both at the Pretura and at the Tribunale. Judgments handed down by the Pretura can be appealed to the Tribunale; judgments handed down by the Tribunale can be appealed to the Corte di appello. In 1998, the average duration of civil proceedings before the Pretura was 2.13 years. The average duration of civil proceedings before the Tribunale was 2.97 years in cases where the Tribunale functioned as a court of first instance and 4.46 years in cases where the Tribunale functioned as a court of appeals. The average duration of civil proceedings before the Corte di appello was 2.75 years. *See* MINISTERO DELLA GIUSTIZIA, LA DURATA DEI PROCEDIMENTI CIVILI IN ITALIA 5 (2000), http://www.giustizia.it/statistiche/statistiche_dog/2001/completa.pdf.

122. *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1914, 1925-28 (1996) (stressing the link between the quality of a state's court system and the state's corporate law and suggesting that corporate law norms can be designed in a way that minimizes dependence on courts).

123. *See* MINISTERO DELLA GIUSTIZIA, *supra* note 121, at 5-6.

124. *See* Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. [EBOR] 765, 783 (2002) (concluding that the 1998 reform of Italian corporate law "grants judges a less marginal role than before").

125. Until 1998, derivative suits were not allowed under Italian corporate law. *See* Jonathan R. Macey, *Italian Corporate Governance: One American's Perspective*, 1998 COLUM. BUS. L. REV. 121, 133 (1998). While they have been legal since 1998, the legal literature indicates that no such suit has ever been initiated. *See* Enriques, *supra* note 124, at 780.

contingent fee arrangements are an essential tool for facilitating shareholder litigation.[126] Consequently, the illegality of such agreements can be a severe blow to the viability of a corporate law regime relying heavily on shareholder litigation as an enforcement mechanism. It should be noted that the problem at hand cannot be eliminated by means of an extensive interpretation of the internal affairs doctrine. Admittedly, it is technically possible for the competent Community institutions to adopt a rule according to which the law of the state of incorporation rather than the *lex fori* governs questions relating to attorneys' fees in corporate matters. However, such a course of action would allow corporations to choose the rules governing attorneys' fees by picking a particular state of incorporation.[127] While this may seem to open the door for all the benefits associated with the free choice concept, the most important result is likely to be a considerable expansion of the already substantial conflicts of interest between corporations and their lawyers.[128] After all, there is a real danger that lawyers will persuade their clients to incorporate in a certain state not because the corporate law of that state is more efficient, but because its rules governing attorneys' fees tend to maximize the lawyers' own revenues. To be sure, one may offer the following objection to this argument: those lawyers advising corporations with regard to their decision as to where to incorporate are not typically paid on a contingent fee basis. Rather, contingent fee arrangements are far more common where lawyers represent shareholders in suits against the corporation. Hence, the lawyers that actually influence the corporation's decision regarding where to incorporate have no incentive to pick a state that tends to promote lucrative contingent fee arrangements. However, as logical as that objection may seem, it is easily refuted. The argument described above does not presuppose that lawyers will pick states that allow, let alone promote, contingent fee arrangements. Rather, the question of whether contingent fee arrangements are admissible will, for practical reasons, have to be decided by the same state

126. *See, e.g.*, ROBERT W. HAMILTON, THE LAW OF CORPORATIONS 541 (5th ed. 2000) (pointing out that most derivative suits are taken on a contingent or open fee basis); Daniel A. Braverman, *U.S. Legal Considerations Affecting Global Offerings of Shares in Foreign Companies*, 17 NW. J. INT'L L. & BUS. 30, 45 (1996) (describing the role of contingent-fee arrangements in enforcing disclosure requirements); John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 812 n.54 (1984) (describing contingent fee arrangements as essential to the enforcement of derivative actions).

127. There is yet another argument why the legality of contingent fee arrangements should not be decided by the state of incorporation. One of the reasons why contingent fees are banned in most countries is that they are thought to have a corrupting influence on attorneys. *See* WALTER K. OLSON, THE LITIGATION EXPLOSION: WHAT HAPPENED WHEN AMERICA UNLEASHED THE LAWSUIT 36-37 (1991). That view is by no means commonly accepted. *See* Pamela S. Karlan, *Contingent Fees and Criminal Cases*, 93 COLUM. L. REV. 595, 610 (1993) (claiming that "it is unclear that contingent fees generally create an incentive to use improper tactics"). However, it does not seem unreasonable to suppose that, on balance, the willingness of lawyers to engage in fraudulent and other inappropriate conduct increases once they are given a direct financial stake in the outcome of litigation. Moreover, it is fair to assume that a lawyer's willingness to engage in unethical behavior does not change from case to case. As a result, the costs of contingent fee arrangements are at least in part borne by the state where the relevant lawyers practice, i.e., the forum state. To avoid negative externalities, it should therefore be the forum state, not the state of incorporation, whose law governs the legality of contingent fee arrangements.

128. The role of conflicts of interests in reducing corporate mobility will be discussed in more detail below. *See infra* text accompanying notes 148-157.

that promulgates the remaining rules on attorneys' fees.[129] However, it is undesirable for this to be the state of incorporation because, if it is, states may try to attract corporations by offering their lawyers generous rules on attorneys' fees.

The practical relevance of this issue in the European Community is hard to estimate. In the past, European states generally prohibited contingent fee arrangements,[130] but that situation is changing. As early as 1991, France adopted a law allowing agreements under which the lawyer receives a supplemental payment if the client wins the case.[131] Similarly, England modified its law to provide some room for contingent fee arrangements. Under the new law, a lawyer who signs a contingent fee arrangement and then wins a case can double the fee that he or she would normally obtain under a standard arrangement.[132] While this approach is still a far cry from the contingency fee-based U.S. system, it is reported to have had some impact already.[133] More importantly, it may be the first step towards further reforms.

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129. Theoretically, one could imagine a federal rule according to which the state of incorporation determines the legality of contingent fee arrangements while the state of the real seat decides all other questions relating to attorneys' fees. However, in practice, such a system would lead to considerable difficulties. Consider, for example, a rule adopted by the forum state according to which minimum fees have to be paid in certain cases. The state of incorporation could easily create a loophole by allowing contingent fee arrangements under which the lawyer is paid only part of his fees unless the suit has been completely successful.

130. *See* JOHN H. MERRYMAN ET AL., THE CIVIL LAW TRADITION: EUROPE, LATIN AMERICA, AND EAST ASIA 1026 (1994) (describing the critical attitude of civil law systems towards contingent fee arrangements); Daniel L. Rubinfeld & Suzanne Scotchmer, *Contingent Fees*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 415, 415-16 (Peter Newman ed., 1998) ("Until recently, West Germany and Spain were the only civil law countries with contingent fees."); W. Kent Davis, *The International View of Attorneys Fees in Civil Suits: Why Is the United States the "Odd Man Out" in How It Pays Its Lawyers?*, 16 ARIZ. J. INT'L & COMP. L. 361, 372 (1999) ("[T]he U.S. is unique in its wide use of contingent fees as a method of financing litigation.").

131. Law No. 71-1130 of Dec. 31, 1971, art. 10, *as modified by* Law No. 91-647 of July 10, 1991, art. 72.

132. That arrangement was first made possible by the Courts and Legal Services Act, 1990, § 58 (Eng.) and the Conditional Fee Arrangement Order, 1995. The Courts and Legal Services Act, 1990, § 58 (Eng.) has been modified by the Access to Justice Act, 1999, § 27 (Eng.). In addition, the Conditional Fee Arrangements Order, (1995) SI 1674 (Eng.), has been replaced by the Conditional Fee Agreements Order, (1998) SI 1860 (Eng.), which in turn has been replaced by the Conditional Fee Agreements Order, (2000) SI 823 (Eng.). However, the 200% limit still applies. *See also* Guido Calabresi & Jeffrey O. Cooper, *New Directions in Tort Law*, 30 VAL. U. L. REV. 859, 863 (1996) (describing the new English rule on contingent fee agreements). It should be noted that even under the old law lawyers were able to charge a maximum uplift of 20% of costs to their client in the event that the client's claim was successful. *See After the Event Cover*, WORLD POL. GUIDE, May 13, 1994, at 1.

133. *See, e.g.*, Gareth Chadwick, *Professional Negligence: The Blame Game*, THE LAWYER, July 15, 2002, at 27 (referring to "the growing army of claimant lawyers using conditional fee arrangements to generate support for shareholder class actions against directors"); Lucy Hickman, *Class of Their Own—The UK's Growing Use of Group Action Litigation and Will It Be as Commonly Used Over Here as It Is in the US*, 98 LAW SOC. GAZETTE 24 (2001) (claiming that most group actions in the United Kingdom are now funded, in part, through the use of contingent fee arrangements); *Directors & Officers; A New Breed*, Post Magazine, September 30, 1999, at 27 (quoting a corporate attorney as saying that the biggest threat of suits against directors comes from a growth in class actions against public companies as a result of conditional fees). *But see In Focus*, CONSUMER L. TODAY, Sept. 24, 2001, at 9 (claiming that in the United Kingdom contingent fee arrangements have become common in personal injury cases but less so in the area of commercial law, where it can be very unclear who is going to win and thus harder to persuade a solicitor to take the case on the basis of contingent fee arrangements).

In sum, a number of frictions can arise between the procedural law of the real seat state and the corporate law of the state of incorporation. For those corporations that wish to avoid litigating outside of their real seat state, such frictions constitute one potential obstacle to choosing the most efficient corporate law.

D. *Language Barriers and Legal Advice*

Another obstacle to corporate mobility in the European Community concerns the availability of legal advice in a language spoken by the firm's management.[134] As of February 2004, the European Community knows no fewer than thirteen languages.[135] With the accession of Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia, this number will increase considerably.[136] As a result, a European corporation seeking to reincorporate in another Member State may face the problem that few lawyers familiar with the law of the new state of incorporation will also speak the language of the corporation's decision-makers. In the short run, at least, that prospect may prevent many corporations from incorporating outside of their real seat state.[137] However, it should be noted that while language barriers may be of considerable importance to small firms who do business mostly in their real seat state, they are unlikely to deter larger corporations who do business in multiple Member States.

E. *The Cost of Changing One's Lawyer*

Corporate mobility may also be reduced as a result of the costs that corporations incur in changing their lawyers. In view of the fundamental differences that characterize the corporate law systems of the various Member States of the European Community, a corporation's traditional legal advisors will often be unable to provide legal counsel once the corporation has reincorporated. As a result, corporations will often have to change their corporate lawyers upon reincorporating in another Member State. Even disregarding a possible shortage of qualified legal advisors, however, changing one's lawyer can be costly. A corporation's traditional lawyer will usually have acquired a substantial amount of firm-specific knowledge, making it easier for her to advise the corporation in legal matters. While the

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134. *See* KIENINGER, WETTBEWERB, *supra* note 18, at 173 (noting that reincorporation in another member state may lead to higher costs for legal advice).

135. These include Danish, Dutch, English, Finish, French, German, Greek, Italian, Portuguese, Spanish, and Swedish. For the establishment of the linguistic rules of the European Community's institutions, see Council Regulation 1/1958 of 15 April 1958, art. 1, O.J. (L 17) 385, as *amended by* Council Decision 95/1/EC, 1995 O.J. (L 1) 1 (Euratom, ECSC).

136. *See* Judy Dempsey, *Date Set for EU Enlargement*, FIN. TIMES (LONDON), Nov. 19, 2002, at 8 (noting that the ten new candidates will join the EU on May 1, 2004).

137. Of course, one might argue that this problem should not be categorized as an obstacle to free choice. Instead, one could consider the availability of multilingual legal advisors to be part of the legal infrastructure on the merits of which the Member States compete. From this perspective, a lack of German-speaking attorneys familiar with U.K. company law is not an obstacle to corporate mobility. Rather, it is simply a circumstance that reduces the attractiveness of the legal product offered by the United Kingdom.

benefits of this knowledge are likely to be reaped at least in part by the lawyer herself in the form of higher fees,[138] the corporation, too, will generally receive part of the gains. After all, given that the lawyer's knowledge about the firm constitutes a transaction-specific asset that cannot—or may not[139]—be profitably used in working for other clients, the corporation is in a very good position to force the lawyer to share the relevant benefits.[140] However, if the corporation reincorporates in another Member State and as a result retains new counsel, any such benefits are lost. Moreover, hiring a new lawyer may be risky. To be sure, large public corporations will often rely on law firms with well-established reputations. As a result, the risk of ending up with unqualified lawyers will usually be small for the companies in question. However, the situation is far more difficult for small and medium-sized companies.[141] The risk of ending up with inferior legal advice is unlikely to be enormous, but it should be kept in mind that the advantages of being incorporated under a more efficient corporate law will also often be moderate, particularly for small and medium-sized corporations. Thus, it is by no means unrealistic to assume that some corporations will consider the benefits of incorporating under a more efficient corporate law to be outweighed by the risk of picking a bad lawyer.

Of course, the above-described problems are not confined to the European Community; they exist in the United States as well.[142] The question arises, therefore, whether there is reason to believe that the problem of changing one's lawyer can be advanced as an argument for why free choice will work less well in the European Community than it does in the United States. At present, two factors suggest that this question has to be answered in the affirmative.

First, U.S. corporations that choose to reincorporate in another state are less likely to have to change their lawyers in the first place. After all, the differences between the corporate law regimes of different states are sufficiently small to ensure that many lawyers are familiar with Delaware corporate law as well as with the corporate law of their home state. Hence, at

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138. *See, e.g.*, N.Y. CODE PROF. RESP., Disciplinary Rule 2-106B(6) (Mary C. Daly ed., 2003) ("[F]actors to be considered in determining the reasonableness of a fee may include . . . [t]he nature and length of the professional relationship with the client.").

139. The relevant rules of professional conduct will usually prevent the lawyer from using any confidential information obtained through his work for a client. *See, e.g.*, N.Y. CODE PROF. RESP., *supra* note 138, Disciplinary Rule 4-101B (restricting the ability of a lawyer to use confidential information).

140. The firm only needs to threaten the lawyer with terminating the relationship. Anxious to protect the value of her firm-specific knowledge, the lawyer will be willing to pass some of the relevant gains on to her corporate client.

141. For small and medium-sized companies, the quality of a lawyer's past work will often be the most important indicator of what the corporation can expect in the future. By contrast, judging the skills of a lawyer who has not yet provided any services to the corporation can be difficult. A lawyer's general reputation may be difficult to ascertain, particularly where the new law firm specializes in the law of another Member State.

142. In fact, the costs of changing from one lawyer to another may well constitute one reason why close corporations for the most part tend to remain incorporated in their real seat state. For a discussion of other possible explanations for this phenomenon, see Ayres, *Judging Close Corporations*, *supra* note 89, at 374-76 (listing a number of factors).

least in those cases in which their corporate client decides to reincorporate in Delaware, these lawyers will be able to continue their role as legal advisers.

Second, and more importantly, changing one's lawyer is likely to be more expensive in Europe than it is in the United States. In part, that is due to very restrictive EC rules on advertising by lawyers; this increases the costs of finding qualified legal advice. Some Member States, such as Belgium, Spain, and Italy, do not, in the words of one scholar, "allow much advertising beyond the sending of brochures to existing clients."[143] Of course, this problem could be remedied via Community legislation. The competent Community institutions would have to enact a rule allowing corporate lawyers to advertise as long as that advertisement is neither misleading nor deceptive.[144] Another far more challenging problem concerns the role of multinational law firms. Such firms can contribute substantially to lowering the costs that corporations bear as a result of having to change their lawyer(s). By using an interstate law firm, corporations can manage to avoid changing law firms, and they will therefore be able to minimize both the risk of losing firm-specific knowledge accumulated by attorneys[145] as well as the danger of ending up with inferior legal advice.[146]

The question then, is whether the formation of interstate law firms will be more difficult in the Community than it is in the United States. At present, this question has to be answered affirmatively for at least two reasons. First, cultural as well as linguistic barriers make the formation of interstate firms more difficult in Europe than it is in the United States. Put simply, a lawyer from New York will find it easier to work with a colleague from Delaware than an Italian lawyer will with her Danish colleague. Second, the prices that can be charged for legal services in the European Community vary considerably more from state to state than they do in the United States, making it harder for the various national offices to achieve the same degree of profitability. As a result, the interests of lawyers in European law firms will be less uniform than those of lawyers in U.S. firms. As Henry Hansmann has

143. *See* Richard L. Abel, *Transnational Law Practice*, 44 CASE W. RES. L. REV. 737, 758 (1994). This is particularly troublesome because under Community law, lawyers located in a particular state have to observe that state's rules on advertising regardless of where they wish to provide their services and regardless of what legal regime they seek to give advice on. *See* Council Directive 77/249, art. 4, 1977 O.J. (L 78) 17 (facilitating the effective exercise by lawyers of the freedom to provide services).

144. As a matter of positive law, such a rule can be based on Article 52 of the EC Treaty, which explicitly provides that "in order to achieve liberalization of a specific service, the Council shall . . . issue directives."

145. In particular, two aspects have to be considered in this context. First, if the law firm's old lawyers and new lawyers work in the same law firm, they will generally find it easier to communicate as a practical matter. Second, the new lawyer has a greater economic incentive to assist the new lawyer if they both work in the same firm and participate in the firm's economic success.

146. Admittedly, it may well be the case that a particular law firm, even though it is highly expert in the corporate law of one state, provides inadequate legal services regarding the law of other states. However, corporate clients will find it easier to learn about such differences in performance than to judge the quality of a firm with whom they have not worked before. After all, a corporation will usually acquire some general knowledge about a particular law firm through an ongoing relationship. In particular, corporations often recruit their in-house legal counsel from the law firms with whom they work, and the relevant personnel is likely to be more or less informed about "what is going on" in their old law firm.

shown, heterogeneous interests tend to increase the costs of ownership considerably.[147] All this does not mean, of course, that there will not be interstate law firms in the European Community. In fact, as documented by the websites of the world's leading law firms, many such firms already exist. However, such firms may not function as efficiently as their U.S. counterparts, and any difference in cost between EC and U.S. firms will have to be borne by the relevant firms' corporate clients.

In sum, European corporations reincorporating in other Member States are more likely than their U.S. counterparts to require changing to new legal counsel, and, in addition, the costs associated with such a change will also tend to be greater in the European context.

F. *Conflicts of Interest on the Part of Lawyers*

Another obstacle to free choice can result from conflicts of interest on the part of lawyers. It has long been known that U.S. corporations—to the extent that they do not incorporate in Delaware—tend to incorporate in their real seat state.[148] Daines has recently suggested that this phenomenon may have less to do with efficiency considerations than with loyalty conflicts faced by corporate lawyers. Local lawyers, specialized in the corporate law of their home state, will generally be unwilling to see their client incorporate in another state.[149] Indeed, empirical data on the incorporation choices of firms making an initial public offering seem to support that conclusion, showing a strong connection between the local or interstate character of law firms and the probability that their corporate clients will incorporate locally or in another state.[150]

With regard to these findings, a caveat seems in order. Contrary to what Daines seems to suggest, the results of his empirical analysis do not necessarily justify the conclusion that conflicts of interest are a major source of inefficient decisions when it comes to choosing the state of incorporation. Daines acknowledges only two possible reasons for the fact that the local or interstate character of a law firm has a strong influence on incorporation decisions: either lawyers tend to overestimate the benefits of their own state's legal system, or they consciously advise their clients to remain in a jurisdiction with inefficient corporate law.[151] However, Daines neglects a third, more innocuous, possibility. As pointed out above, changing one's lawyer can be costly. Hence, even a perfectly well-informed lawyer bent on the maximization of shareholder value will have to balance the costs of remaining incorporated in a jurisdiction with inefficient corporate law against

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147. *See* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 89-91 (1996) (describing how diverging interests affect the costs of ownership in employee-owned firms).

148. *See, e.g.*, David A. Skeel Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 DEL. L. REV. 1, 36 (1998).

149. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1584-86, 1595 (2002) (pointing out that the personal interests of corporate lawyers may influence incorporation decisions).

150. *See id.* at 1595.

151. *See id.* at 1586 (noting that "[t]he local lawyer's preference for local law may be the product of the lawyer's imperfect information rather than greed").

the costs that her corporate client faces as a result of changing to another lawyer.[152]

Nonetheless, there is still reason to suspect that conflicts of interest on the part of lawyers will prevent at least some corporations from incorporating in a state with more efficient corporate law, even though reincorporation would benefit the corporation. The fact that such conflicts of interest exist is fairly obvious even in the United States.[153] An attorney specializing in the corporate law of her home state may lose her corporate clients once they reincorporate elsewhere. Even if the attorney manages to retain her position as legal counsel for a corporation that has (re)incorporated in another state, her revenue from that client will probably suffer. In particular, at least some of the client's legal business may have to be undertaken by lawyers located in the new state of incorporation. Delaware law, for example, provides that court appearances and filings must be made by lawyers admitted to the local bar.[154]

In the context of this Article, the important point is that the relevant conflicts of interest are bound to be substantially greater in the European Community than they are in the United States. As will be shown in more detail below,[155] a European corporation's decision to reincorporate will typically mean that its old lawyer can no longer give advice on the internal matters of the corporation. Moreover, at least under the present jurisdictional rules, European corporations are even more exposed to litigation in the state of incorporation than their U.S. counterparts.[156] As a result, lawyers in the real seat state will lose additional litigation fees. Furthermore, it should be noted that the existence of interstate law firms is unlikely to make this problem disappear. Corporate lawyers working in the less popular states of incorporation may fear that once all major clients have reincorporated elsewhere, the partnership will somehow be dissolved.[157] In sum, while it is difficult to determine the precise relevance of the issue, conflicts of interest on the part of lawyers are likely to prove a far more substantial obstacle to free choice in the European Community than in the United States.

G. *Summary*

All in all, the analysis undertaken in this Part paints a mixed picture. Presently, the more substantial obstacles to free choice are those of a legal nature. They include the risk that the Member States will adopt pseudo-foreign corporation statutes, the inability of corporations to reincorporate

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152. In other words, even if a corporation advised by local law firms chooses to incorporate locally, and even if the real seat state's corporate law is less efficient than that of Delaware, the decision to incorporate in the former may still be efficient.

153. *See* Daines, *supra* note 149, at 1559, 1584-86, 1595 (pointing out that the personal interests of corporate lawyers may influence incorporation decisions).

154. *See* DEL. SUP. CT. R. 12; DEL. CH. CT. R. 170. *See also* Macey & Miller, *supra* note 95, at 494.

155. *See infra* text accompanying notes 221-233.

156. *See supra* text accompanying notes 96-118.

157. Of course, the same concern could theoretically arise in the United States. However, the relative uniformity of U.S. corporate law makes it far easier for corporate lawyers to change their field of practice from one corporate law regime to another.

without having to transfer their assets one by one, the taxation of hidden assets upon reincorporation, and the rules governing adjudicative jurisdiction in the European Community. Although these obstacles are bound to limit free choice sharply while they exist, they can be removed by means of Communiy legislation.

Much harder to eliminate are the practical barriers to free choice: friction between the judicial system of the real seat state and the corporate law of the state of incorporation, a shortage of multilingual lawyers, the cost of changing one's lawyer, and conflicts of interest on the part of lawyers. These practical obstacles, however, matter most to small and medium-sized corporations—the businesses which tend to incorporate locally even in the United States.[158] Moreover, most of these practical barriers to free choice are likely to grow weaker over time, as the corporate law of one or two jurisdictions begins to dominate.

In sum, therefore, while the European Community cannot hope to afford European corporations the degree of free choice enjoyed by U.S. corporations, there is reason to believe that over time Europe will not lag too far behind the United States.

III. SHOULD THE EUROPEAN COMMUNITY GRANT FREE CHOICE?

The question remains whether it is desirable that European corporations be granted free choice. Part III answers this question in the affirmative. Compared to the option of harmonizing European corporate law, free choice has important benefits. Most importantly, it will very likely lead corporations to be governed by more efficient law than will harmonization. Moreover, free choice will contribute more to the creation of a rich and coherent body of case law than will harmonization. These benefits make free choice a preferable alternative to harmonization, and furthermore, the case for free choice is probably stronger in Europe than it is in the United States.

A. *The Quality of Substantive Corporate Law Rules*

The central advantage of free choice is that it will probably lead corporations to be governed by better corporate law than will harmonization. This prediction cannot be made with absolute certainty; nevertheless it appears well-grounded. Three primary characteristics distinguish free choice from harmonization. First, free choice allows corporations to choose from among several corporate law regimes according to their preferences.[159] Second, states can compete for corporate charters.[160] And third, any influence exerted by lawmakers at the federal level takes on an indirect form. To the

158. In 1999, 4.9 million corporations filed corporate income tax returns. *See* U.S. CENSUS BUREAU, STATISTICAL ABSTRACTS FOR THE UNITED STATES 2002, NO. 699: NUMBER OF RETURNS, RECEIPTS, AND NET INCOME OF BUSINESS: 1980-1999, at 471 (2002), http://www.census.gov/prod/2003pubs/02statab/business.pdf. Yet in the same year, only about 452,001 legal entities chose to make Delaware their legal home. E-mail from Nicole Hall, Delaware Division of Corporations, to Jens Dammann (Mar. 3, 2004, 14:19:39 EST) (on file with The Yale Journal of International Law).

159. *See, e.g.*, Garfield, *supra* note 1, at 122.

160. *See, e.g.*, ROMANO, GENIUS, *supra* note 7, at 6.

extent that federal law creates the conditions for free choice, the influence of federal lawmakers on the shape of corporate law rules is only guaranteed by a threat—the possibility of federalizing corporate law.[161] As shown below, each of these factors justifies—or at least does not undermine—the claim that the corporate law rules resulting from free choice will be superior to those resulting from harmonization.

1. *Corporate Demand for Efficient Rules*

The efficiency of free choice depends primarily on the preferences of corporate decision-makers. If corporate decision-makers tend to pick the most efficient state law regime, then free choice is likely to improve the quality of rules that govern corporations. If, by contrast, corporations tend to pick relatively inefficient rules, then harmonization limits the adverse consequences of such preferences.[162] The central question, therefore, is to what extent corporations can be relied upon to choose efficient over inefficient corporate law in making their reincorporation decisions.

a. *Can Managerial Opportunism Be Contained?*

The most well-known problem in this context is, of course, that of managerial opportunism. In the United States, this issue has long been at the heart of the debate on free choice. Under U.S. law, the decision to reincorporate traditionally involves both managers and shareholders. First, the board must decide to reincorporate.[163] Then, the shareholders must give their approval.[164] Given that managers control the agenda, there is a certain risk that managers will put their own interests above those of shareholders. For example, managers seeking to cement their own position may be tempted to choose a corporate law regime that curtails or eliminates the possibility of a hostile takeover, even though such takeovers may benefit shareholders.[165]

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161. The fact that the threat of federal intervention may be one of the factors shaping Delaware law—both in terms of legislation and case law—has long been acknowledged. *See, e.g.*, William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1892-98 (1995) (suggesting that the desire to avoid federal intervention may have influenced the shape of Delaware corporate law, particularly in the area of takeover law); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512 (1989) (noting that because of the threat of federal intervention, "Delaware now has an incentive not to lead in the adoption of innovative managerial rules"); Skeel, *supra* note 148, at 35 (claiming that "even die-hard critics of Delaware's role in corporate law have acknowledged that the threat of federalization has had beneficial effects on Delaware lawmaking"); Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551, 597 n.200 (1987) (suggesting that Delaware courts may act in such a manner as to avert the threat of federal intervention).

162. It is important to note that both these statements are true regardless of whether states compete for corporate charters.

163. *See, e.g.*, General Corporation Law, DEL. CODE ANN. tit. 8, §§ 241, 251 (2003). In the literature, see, for example, Bebchuk, *Desirable Limits*, *supra* note 6, at 1458; John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1674-76 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-80 (1989).

164. *See supra* note 163. *See also* ROMANO, ADVANTAGE, *supra* note 1, at 65.

165. Indeed, one of the main arguments against free choice in corporate law has been that it

The decisive question, then, is how well that risk is contained. Here the views diverge. Advocates of free choice argue that the conflict of interest has been overstated. They point to the pressure exerted by capital markets and the requirement that shareholders approve any decision to reincorporate.[166] Critics of the free choice system have been less optimistic. They suggest that reincorporation decisions will lead to inefficient results to the extent that they involve issues that—like takeover regulation—are "significantly redistributive" in that they involve a significant trade-off between important managerial and shareholder interests.[167] Similarly, they argue, market pressure will fail with regard to issues that directly affect the strength of market discipline.[168]

Although one might argue that the evidence favors the more optimistic of the two above-mentioned views, this Article does not seek to resolve the debate. Rather, there is a different point to be made. In the European Community, corporations are likely to migrate towards the jurisdiction with the most efficient corporate law—regardless of how one judges the situation in the United States—because the conflicts of interests are likely to be better contained in the European Community as compared to the United States.[169]

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allows managers to pick a jurisdiction with strict antitakeover legislation. *See, e.g.*, Bebchuk & Ferrell, *Federalism*, *supra* note 6, at 1199 (noting that "[t]akeover law is one important area in which state competition is likely to fail").

166. *See, e.g.*, ROMANO, ADVANTAGE, *supra* note 1, at 65; ROMANO, GENIUS, *supra* note 7, at 18-19.

167. Bebchuk, *Desirable Limits*, *supra* note 6, at 1461-1467; Lucian Bebchuk & Ferrell, *Federalism*, *supra* note 6, at 1172.

168. Bebchuk, *Desirable Limits*, *supra* note 6, at 1467-73.

169. A related claim is made by David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423, 439 (1991). He also suggests that managerial opportunism might be better contained in the European Community than in the United States. However, he offers a different reason than the one stressed in this Article. Charny points out that "particularly in the German corporate environment, corporate employees and bank creditors exert more powerful influences on managerial decision-making, either through direct board representation or more indirect business ties." *Id.* (footnotes omitted). Such stakeholders, he argues, have sufficient incentives to monitor the directors' reincorporation decisions. *Id.* For several reasons, however, that reasoning is unconvincing. First, it should be noted that the German corporate environment cannot be found throughout Europe. In the United Kingdom, for example, the situation looks entirely different. There, market capitalization is high, and there are no rules imposing co-determination. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 663 (1999) (noting that stock market capitalization in the United Kingdom far exceeds German standards, if set in relation to GDP); Sørensen & Neville, *supra* note 9, at 187 (noting that the United Kingdom does not have rules on employee participation); Stith, *supra* note 8, at 1589 (pointing out that the United Kingdom does not require employee participation in management). Second, and more importantly, it seems highly questionable to assume that the stakeholders which Charny has in mind will use their influence to prevent the kind of managerial opportunism that free choice allegedly allows. In particular, it should be recalled that those scholars who perceive a race to the bottom focus mainly on antitakeover legislation. *See* Bebchuk & Ferrell, *Federalism, supra* note 6 (claiming that state competition leads states to engage in a race to the bottom with regard to antitakeover legislation); Bebchuk & Ferrell, *New Approach*, *supra* note 6, at 130 (arguing that state competition leads "states to protect incumbent management excessively from takeovers"). In other words, the concern that corporations will migrate to states with less efficient corporate law is largely identical with the fear that corporations will reincorporate in states that unduly protect managers against hostile takeovers. Yet it is precisely with regard to hostile takeovers that the European stakeholder models are entirely unimpressive. Hostile takeovers are almost unknown in Germany, and the same is true in Belgium, France, Italy, the Netherlands, and Spain. *See, e.g.*, Clas Bergstrom et al., *The Regulation of Corporate Acquisitions: A Law and Economics Analysis of European Proposals for Reform*, 1995

This conclusion can be explained in the following way. First, it is possible to prevent corporations from reincorporating in jurisdictions with less efficient corporate law by structuring the corporate decision-making process accordingly. Second, the Member States of the European Community are likely to take the necessary steps to contain conflicts of interest even without Community intervention.

i. *Will Corporations Refrain from Incorporating in States with Inferior Law?*

Consider, first, the claim that it is possible to prevent corporations from reincorporating in states with less efficient corporate law. The justification of that statement should be fairly obvious. By imposing a sufficiently large supermajority and/or "majority of the minority" requirement, it will generally be possible to ensure that shareholders will not vote against their own best interests. That is true even though it may be necessary to set the relevant threshold rather high in order to compensate for collective action problems.

ii. *The Incentive for Member States To Prevent a Corporate Race to the Bottom*

The more challenging problem is the claim that Member States of the European Community will structure law governing the decision-making process of corporations in such a way as to prevent corporations from moving to jurisdictions with less efficient corporate law. Again, however, the theoretical basis for this assertion is fairly straightforward. As will be shown below, a European corporation's decision to reincorporate usually means that its corporate law business is lost to the lawyers of the real seat state.[170] Hence, the Member States, each under pressure from the local bar, can be expected to compete vigorously for corporate charters. As a result, they have an incentive to draw up strict requirements for corporations willing to reincorporate in another jurisdiction. Imposing a far-reaching supermajority requirement is an easy way of doing so. Admittedly, not all Member States have an incentive to pursue such an approach. Smaller states that hope to become Europe's Delaware may consider the introduction of a supermajority requirement of the type at issue to be a bad strategy. After all, at least in the beginning, they have few corporate charters to lose and hence little to gain from a supermajority requirement. At the same time, they may not want to adopt provisions that foreign corporations might interpret as lock-in mechanisms. However, the larger Member States that are currently home to large numbers of corporations have little reason to abstain from the course of conduct described above.

COLUM. BUS. L. REV. 495, 505 (noting the practical impossibility of hostile takeovers in Belgium, France, Germany, Italy, the Netherlands, and Spain); Brian R. Cheffings, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 502 (2001) (pointing out that hostile takeovers are largely unknown in Germany); Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Governance Environment*, 61 FORDHAM L. REV. 161, 182 (1992) (noting that only two Italian corporations are even theoretically subject to hostile takeovers).

170. *See infra* text accompanying notes 221-233.

Indeed, empirical data tend to support the above-made prediction. The prevailing tendency among Member States in the European Community is to do everything to keep local businesses incorporated at home. The now illegal real seat rule is part of that effort, as is the lack of clear-cut provisions allowing corporations to transfer only their statutory seat to other Member States or to undertake cross-border mergers.[171] Once again it should be recalled that even the United Kingdom, a paradigm of Member State adherence to the state of incorporation doctrine, does not allow corporations to transfer their statutory domicile elsewhere[172] and does not provide a clear basis for transnational mergers.[173] In sum, the Member States traditionally do their utmost to prevent a locally operating business from changing its statutory domicile.

It is also noteworthy that even for mergers between domestic corporations, Member States often impose relatively strict requirements. Such purely domestic mergers are governed by the Third Council Directive of 9 October 1978 concerning mergers of public limited liability companies, hereinafter referred to as the Merger Directive.[174] Despite its name—which is misleading against the background of U.S. legal terminology—the directive particularly applies to mergers between stock corporations.[175] The Merger Directive mandates that any merger be approved by the shareholders of both merging companies and that, in each case, a supermajority of at least two-thirds of the votes is needed.[176] When at least half of the subscribed capital is represented at the shareholder meeting, the law of the Member States may provide that a simple majority of the votes shall suffice.[177] Many Member States have not made use of the latter possibility,[178] and others have even gone

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171. *See supra* text accompanying notes 56-79.

172. *See supra* text accompanying note 61.

173. *See supra* note 78.

174. Third Council Directive 78/855/EEC of 9 October 1978 Based on Article 54(3)(g) of the Treaty Concerning Mergers of Public Limited Liability Companies, 1978 O.J. (L 295) 36 [hereinafter Merger Directive].

175. *See id.* art. 1 (listing the various types of corporations that fall under the Merger Directive).

176. Article 7(1) of the Merger Directive reads:

> A merger shall require at least the approval of the general meeting of each of the merging companies. The laws of the Member States shall provide that this decision shall require a majority of not less than two thirds of the votes attaching either to the shares or to the subscribed capital represented. The laws of a Member State may, however, provide that a simple majority of the votes specified in the first subparagraph shall be sufficient when at least half of the subscribed capital is represented. Moreover, where appropriate, the rules governing alterations to the memorandum and articles of association shall apply.

Id. art. 7(1).

177. *Id.*

178. This is true, for example, in the United Kingdom. *See* GILLESSEN, *supra* note 74, at 366 n.105 (noting that the United Kingdom has not made use of the possibility afforded by the Merger Directive to lower the supermajority requirement when at least 50% of the subscribed capital are represented). The same situation exists in Germany, where a three-fourths requirement exists regardless of how many shares are represented at the shareholder meeting. *See* § 65(1)(1) Umwandlungsgesetz (UmwG) [Reorganization Act], v. 28.10.1994 (BGBl. I 3210, berichtigt 1995 I S.428) ("The merger resolution requires a majority consisting of at least three quarters of the subscribed capital that is represented at the shareholder meeting."). By contrast, Spanish law has imposed the supermajority requirements only the extent that they are imposed by Community law. In other words, a merger requires a two-thirds majority in both companies, but if 50% or more of the subscribed capital is

beyond the directive in setting a threshold higher than the two-thirds majority requirement.[179] Given the additional incentive to prevent corporations from reincorporating elsewhere, it is reasonable to assume that now that the real seat rule has been abolished the Member States will start imposing even harsher supermajority requirements with regard to cross-border mergers.

This raises the following question: if state competition for corporate charters is likely to drive the Member States of the European Community to adopt strict supermajority requirements with regard to reincorporation decisions, why has the same not happened in the United States? After all, while a few U.S. states demand a two-thirds majority for a reincorporation decision,[180] in most states a simple majority will suffice.[181] This is due to the limited incentive most states have to keep locally operated business incorporated at home; as Marcel Kahan and Ehud Kamar have shown, the vast majority of U.S. states impose insignificant franchise fees.[182] Moreover, the financial losses that the local bar suffers if a corporation decides to reincorporate elsewhere are also limited.[183] To be sure, a corporation reincorporating in Delaware will henceforth give some of its business to Delaware lawyers, especially in the field of corporate litigation. However, given that Delaware lawyers enjoy no monopoly with regard to legal advice on Delaware law, the bulk of the corporation's legal business will continue to be handled by lawyers in the state of incorporation. In sum, most states do not have a strong incentive to make it hard for local corporations to incorporate elsewhere.

The more interesting question is why Delaware has never sought to secure its position as the leading state of incorporation by imposing a supermajority requirement with regard to reincorporation decisions. One will recall that in 1988, Martin Lipton of Wachtell, Lipton, Rosen & Katz, a leading M&A law firm, sent a notorious memorandum to his clients criticizing the Chancery court's takeover jurisprudence and advising clients that it might be time to migrate out of Delaware.[184] To minimize the risk of a mass exodus

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represented, a simple majority of the votes cast is sufficient. *See* STEIGER, *supra* note 63, at 112.

179. This is the situation, for example, in Germany and Austria. According to § 65 of the German Mergers Act, a merger between two stock corporations has to be approved by at least three quarters of all votes cast. *See* § 65 UmwG, *supra* note 178. An equivalent rule can be found in Article 221 of the Austrian Stock Corporations Act. *See* Aktiengesetz [Stock Corporation Act] BGBl. 98/1965, art. 221.

180. Reincorporation usually takes the form of a merger with a corporation formed under the law of the new state of incorporation, and a few states require a two-thirds majority. *See* MASS. ANN. LAWS Ch. 156, § 46A(3) (Law. Co-op. 2004); N.Y. BUS. CORP. LAW § 903(a)(2) (McKinney 1986); OHIO REV. CODE ANN. § 1701.78(F) (West 1994); TEX CORPS. & ASS'NS CODE ANN. § 5.03(A)(1) (Vernon 1980 & Supp. 1984).

181. *See* JAMES D. COX ET AL., CORPORATIONS 586 (1997). *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 251(c), 252(c) (2002); MODEL BUS. CORP. ACT § 73 (1969); REV. MODEL BUS. CORP. ACT § 11.03 (1984).

182. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 687 (2002) (pointing out that forty-five states, including the states viewed as Delaware's leading competitors, charge companies that are incorporated in them either a low flat tax, or a tax based on the amount of business conducted in the state, or both).

183. *See id.* at 694-99 (arguing that the additional legal business generated by a state's success in the charter market is of limited relevance).

184. *See* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1959 n.95 (1991) (quoting the relevant passage from the memorandum).

of corporations, could Delaware not simply have introduced a supermajority requirement to keep corporations incorporated at home? After all, if the claim that loyalty conflicts can be prevented via supermajority requirements is correct, one could argue that such an approach should have guaranteed Delaware's position in the charter market by preventing managers from migrating to other states in search of greener pastures—states that provide managers with more protection from takeovers. While this reasoning seems plausible at first glance, there is at least one important reason why Delaware could not embark on such a course of conduct. Part of the secret to Delaware's success in the market for corporate charters lies in its reputation as a state that is responsive to corporate needs.[185] If Delaware had imposed a supermajority requirement ex post, thereby locking corporations in, the effect on its reputation probably would have been disastrous. Although Delaware might have succeeded in preventing corporations from migrating elsewhere—a goal that it has largely achieved anyway—foreign corporations might have been deterred from reincorporating in Delaware, judging the state to be unreliable. Herein lies a decisive difference between the situation in the United States and in Europe. Given that the Member States of the European Community have traditionally prevented corporations from reincorporating elsewhere, the imposition of supermajority requirements is unlikely to reflect negatively on a state's reputation for reliability. In sum, the failure of most U.S. states to impose supermajority requirements concerning reincorporation decisions does not imply that the Member States of the European Community will act likewise.

iii. *Should Community Law Make It Easier for Shareholders To Force Corporations To Reincorporate?*

Obviously, supermajority requirements can prevent corporations from migrating to jurisdictions with less efficient corporate law, but can do little to persuade managers to reincorporate in jurisdictions with more efficient corporate law. Against this background, it may seem tempting to consider a recent proposal advanced by Lucian Bebchuk and Assaf Hamdani. They suggest that the U.S. Congress should adopt a mandatory rule enabling shareholders to initiate and approve by vote a proposal to reincorporate in a different state.[186] That way, shareholders could not only prevent their corporation from migrating towards jurisdictions with less efficient corporate law, but could also ensure that the corporation seeks to incorporate in a state with more efficient law.

At least in the European context, however, that suggestion makes little sense. It should be noted first that the inability of shareholders to initiate reincorporation decisions does not present too much of a problem as long as

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185. *See, e.g.*, ROMANO, GENIUS, *supra* note 7, at 38; Kahan & Kamar, *supra* note 182, at 726 (acknowledging the importance of Delaware's reputation in the market for corporate charters).

186. Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 611-12 (2002) [hereinafter Bebchuk & Hamdani, *Reconsidering the Competition*].

state law—via supermajority requirements—ensures that corporations do not migrate to jurisdictions with less efficient law. After all, for various reasons, there will always be *some* managers who decide to reincorporate in a state with more efficient law even if that means less protection against hostile takeovers. For example, a corporation may wish to signal to the market that antitakeover defenses are not needed, or the corporation's shareholders may succeed in pressuring managers to adopt a course of conduct that maximizes shareholder wealth. Against this background, the proposal advanced by Bebchuk and Hamdani is not really necessary to assure a gradual migration towards those jurisdictions whose corporate law is most efficient.

However, it is not difficult to see that the model that Bebchuk and Hamdani envision is bound to destroy the very mechanism that promises to contain the problem of managerial opportunism in the European Community. If a Community rule were to provide that shareholders could initiate, and with a simple majority adopt, a decision to reincorporate elsewhere, then the Member States could no longer effectively prevent managerial opportunism by means of supermajority requirements. After all, the corporation's management would only need to convince one or more shareholders to initiate the desired reincorporation decision. To be sure, Community law could try to prevent this result by imposing a supermajority requirement. However, if the relevant threshold is set high enough to minimize managerial opportunism, it is also bound to be useless as an instrument enabling shareholders to bypass the corporation's management in order to reincorporate elsewhere.

Thus, it seems reasonable to doubt the effectiveness or utility of the Bebchuk-Hamdani proposal. To be sure, the afore-described considerations are not necessarily important in the United States, where most states, in fact, do not have substantial incentives to impose supermajority requirements as a precondition of reincorporation. In practice, furthermore, most states do not impose such requirements. In the European Community, however, a federal intervention in this regard could be more damaging. European states have stronger incentives to prevent corporations from re-incorporating elsewhere, because of, among other factors, a desire to generate lawyers fees at home. Thus in the European Community, a rule with the unintended consequence of diluting restrictions on managerial opportunism—albeit in the name of shareholder empowerment—could be counter-productive.

b. *Can Shareholder and Employee Opportunism be Contained?*

It was suggested above that, in the Community setting, managerial opportunism can be sufficiently contained so as to prevent corporations from migrating towards corporations with inefficiently pro-managerial law and to ensure that, over time, corporations will migrate towards those states that offer the most efficient corporate law. There is, of course, an obvious objection to that scenario: managers are not the only ones facing conflicts of interest. Furthermore, some Member States of the European Community traditionally give employees a voice in the management of the corporation.[187] In addition, majority shareholders may feel tempted to call for reincorporation in those states whose law inefficiently benefits majority shareholders at the expense of the minority. The question, therefore, is whether Europe might avoid managerial opportunism, only to witness a race to the bottom for different reasons. That these problems have not occurred in the United States is of little relevance. After all, U.S. corporate law has never resorted to codetermination, and share ownership in the United States tends to be widely dispersed.[188]

i. *Employee Opportunism*

There is little reason to believe that employees will be able to abuse their influence in the corporation for the purpose of migrating to jurisdictions with less efficient corporate law. Even the most far-reaching laws of codetermination, as found in Germany,[189] do not give employees sufficient influence to force a corporation to reincorporate. German law requires any merger to be approved by the shareholders,[190] and the management of German corporations is not really at risk of being dominated by the firm's employees. German corporations that fall under the so-called "Codetermination Act" are required to have a two-tier board structure, consisting of the management board (Vorstand) and the supervisory board (Aufsichtsrat).[191] The corporation's employees are represented on the supervisory board, where they have a number of seats equal to those occupied by the representatives of shareholders.[192] However, the voting process is structured in such a way as to ensure that the shareholder representatives command the swing vote.[193] Also, at least one of the employee representatives is elected by managerial employees as a separate group, and the latter will not always side with "ordinary" workers.[194] In any case, even if the employee representatives in a

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187. For a survey of European rules on codetermination, see Elmar Gerum & Helmut Wagner, *Economics of Labor Co-Determination in View of Corporate Governance*, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 341, 352-53 (Klaus J. Hopt et al. eds., 1998).

188. *See, e.g.*, Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 256 (2002) (listing data on the dispersion of stock ownership in various countries).

189. *See* Gerum & Wagner, *supra* note 187, at 352-53.

190. *See* § 13(1) UmwG, *supra* note 178 ("The Merger Agreement only becomes valid, when the shareholders of the legal persons involved have consented by resolution (merger resolution).").

191. German stock corporations always have a two-tier board structure. *See* §§ 76-117 Aktiengesetz (AktG) [Stock Corporations Act], v. 6.9.1965 (BGBl. I S.1089). Limited liability companies (Gesellschaften mit beschränkter Haftung) usually have a single board. *See* § 52 Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG) [Limited Liability Company Act], v. 20.4.1892 (RGBl. S. 477). However, once such companies fall into the scope of application of the codetermination laws, they also have to adopt the two-tier board structure. *See* § 6(1) Gesetz über die Mitbestimmung der Arbeitnehmer (MitbestG) [Codermination Act], v. 4.5.1976 (BGBl. I. S.1153).

192. *See* § 7(1) MitbestG, *supra* note 191.

193. The chairperson has an additional vote whenever the supervisory board is deadlocked. *Id.* § 29(2). If the board members cannot agree on a chairperson, the shareholders' representatives elect the chairperson. *Id.* § 27(2).

194. *See* Dammann, *supra* note 50, at 621 (noting that the interests of managerial employees may diverge from those of "ordinary" workers). The only exception to this rule can be found in the coal and steel industry. There, shareholder representatives and employee representatives each hold five seats. *See* § 4(1) Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der

German corporation were able to determine the state of incorporation, they would have nowhere to go. After all, as mentioned before, the other Member States have far less demanding laws with respect to codetermination or do not have any such rules at all.[195] In general, employee opportunism is extremely unlikely to spark a race to the bottom in the European Community.

ii. *Shareholder Opportunism*

A far more significant question is whether majority shareholders can pressure corporations to reincorporate in jurisdictions where the law permits the majority bloc to take advantage of minority shareholders. Such a development, however, is relatively unlikely. As pointed out above, Member States have strong motives for doing everything in their power to keep domestic corporations from incorporating elsewhere. In particular, local attorneys are likely to pressure lawmakers to pursue this course of action. Hence, to the extent allowed by Community law, lawmakers are likely to adopt rules ensuring that reincorporation cannot be used as a means of exploiting minority shareholders. The legal mechanisms to achieve that goal are well-known. They include, in particular, the already-mentioned supermajority requirements,[196] majority-of-the-minority requirements,[197] rights of appraisal,[198] and fiduciary duties.[199]

Admittedly, one may wonder whether the political clout of corporate attorneys is truly strong enough to outweigh the influence of majority shareholders, the latter presumably lobbying for lax reincorporation rules. Indeed, common sense seems to suggest that there will be at least some Member States where majority shareholders will at some point gain the upper hand. Upon closer examination, however, that argument proves feeble at best.

To begin with, there are historical facts to be considered. Over the years, the Member States have been astonishingly consistent in rejecting the state of incorporation doctrine as a means for circumventing local corporate law. In particular, one should recall the traditional adherence to the real seat

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Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie [Montan-Mitbestimmungsgesetz] [Law Pertaining to the Participation of Workers in the Supervisory Boards and Managing Boards of Companies in the Coal, Iron and Steel Industries], v. 21.5.1951, (BGBl. I S.347). The supervisory board includes one additional "neutral" director. The eleventh member, the so-called "neutral member" is elected by the shareholders, but must also be confirmed by at least three of the five shareholders' representatives and, more importantly, by three of the five workers' representatives. *See* §§ 4(1), 8(1) [Montan-Mitbestimmungsgesetz]. However, the neutral director has no reason to abuse his influence to assist the employee representatives in moving to a more employee-friendly jurisdiction.

195. Nor is it likely that any state will seek to attract corporate charters by adopting stricter rules on codetermination. Given that even in Germany employees will hardly ever be able to choose the state of incorporation, such an approach would not be particularly promising as a strategy to attract corporations.

196. *See supra* text accompanying note 186.

197. As regards the effects of such a requirement, see *In re* Aquila, Inc., Shareholders Litigation, 805 A.2d 184, 188 (Del. Ch. 2002).

198. For a detailed analysis of the role of appraisal statutes, see Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995).

199. In Germany, for example, fiduciary duties imposed on majority shareholders have come to play a central role in protecting minority shareholders. *See* KARSTEN SCHMIDT, GESELLSCHAFTSRECHT 799-803 (2002) (giving an overview of the relevant case law and legal doctrine).

doctrine[200] and the fact that even those Member States—like the United Kingdom or the Netherlands—that have followed the state of incorporation doctrine have been reluctant to allow their corporations to reincorporate elsewhere.[201] It seems reasonable to conclude, therefore, that the political voices trying to prevent the circumvention of local corporate law are considerably more influential than those favoring that option.

In addition, there is a theoretical argument to be taken into account. It may be the case that majority shareholders constitute a powerful special interest group. Furthermore, it is reasonable to assume that they will use their political influence as a means of exploiting minority shareholders. However, the question remains why they would do so by calling for lax rules on reincorporation. At least in the European context, the strategy would be unwise. The far more attractive course of action would be to lobby for substantive corporate law rules allowing for the exploitation of minority shareholders. This becomes clear as one considers the political obstacles to both approaches.

Consider first the prospect of lobbying for lax substantive rules that could allow for the exploitation of minority shareholders. Such rules might well be opposed by minority shareholders, who—as a result of collective action problems—tend to lack substantial political power. They might also be opposed by well-intentioned politicians and scholars interested in the protection of minority shareholders and the protection of capital markets in general. Finally, some corporations may be opposed to such rules, knowing that they would adversely affect the value of their shares, although these concerns will often be overcome by allowing corporations to opt into more rigorous rules.

Next, consider the possibility that majority shareholders lobby for lax rules on reincorporation. In that case, all those opposing lax substantive rules will very likely raise their voices in protest. In addition, however, there are other groups that will probably seek to prevent such legislation. To begin with, corporate lawyers who may not mind the exploitation of minority shareholders will be dismayed at the idea of losing their clients in the process. Second, to the extent that the old state of incorporation has some form of mandatory worker codetermination regime, organized labor is likely to protest as well. After all, while reincorporation decisions may be aimed primarily at circumventing rules protecting minority shareholders, corporations are also likely to end up in jurisdictions with weaker or no rules on codetermination. Furthermore, there are the interests of lawmakers to be considered. As long as corporations remain incorporated locally, lawmakers can use their influence to extract benefits such as campaign contributions.[202] Once corporations incorporate elsewhere, however, that possibility diminishes. Hence, from the

200. *See supra* text accompanying note 9.

201. *See supra* text accompanying notes 59-78.

202. The risk that lawmakers use their position to extract benefits from interest groups is well known. *See, e.g.*, FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION 12-13 (1997); David A. Strauss, *Corruption, Equality, and Campaign Finance Reform*, 94 COLUM. L. REV. 1369, 1380-82 (1994).

individual lawmaker's perspective, it is more attractive to enact lax substantive rules than to lower the standards for reincorporation decisions. Moreover, the benefits of lobbying for lax rules on reincorporation are fraught with uncertainty. As pointed out above,[203] it is as yet unclear to what degree the Member States will be allowed to enact pseudo-foreign corporation statutes. Hence, majority shareholders will be reluctant to expend considerable resources lobbying for lax reincorporation rules, because they know full well that the benefits of such rules may subsequently be eliminated by legislation concerning the rights of pseudo-foreign corporations.

Finally, there is the risk of public scrutiny to be considered. Interest groups are most effective when they concentrate on matters of a technical character that do not attract too much public attention.[204] However, in the European context, that condition is far more likely to be fulfilled with regard to substantive corporate law rules than with regard to the rules governing reincorporation decisions. Indeed, given Europe's traditional preference for the real seat doctrine, the endless warnings against a race to the bottom,[205] and the number of interests touched by legislation on reincorporation, any effort to facilitate reincorporation decisions is bound to attract plenty of attention. In sum, majority shareholders seeking to exploit minority shareholders are unlikely to lobby for lax reincorporation standards. Rather, they are far more likely to concentrate on substantive corporate law provisions.[206]

One might attempt to refute that reasoning by pointing out that it is fairly easy to reincorporate under U.S. law, but the objection is unconvincing. Most of the factors which make it unattractive to lobby for lax reincorporation standards in Europe are lacking in the United States. For example, U.S. corporate lawyers as a group are far less likely to oppose lax reincorporation provisions than their European counterparts, because many of them are trained in Delaware law. Indeed, given that large corporations are particularly likely to incorporate in Delaware in the first place,[207] the largest and politically most influential law firms across the nation are bound to be particularly interested in rules that make it easy for corporations to reincorporate. Hence, a U.S. state's corporate lawyers, as a group, will not necessarily oppose rules facilitating reincorporation decisions. Moreover, U.S. corporate law has traditionally rejected mandatory rules on worker codetermination.[208] As a

203. *See supra* text accompanying note 38.

204. *See, e.g.*, Donald J. Kochan, *"Public Use" and the Independent Judiciary: Condemnation in an Interest-Group Perspective*, 3 TEX. REV. L. & POL. 49, 81 (1998) (noting that interest groups are particularly effective at controlling the flow of information to both the public and legislators, when it comes to more complex issues); Kozyris, *supra* note 45, at 67-68; Jonathan R. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277, 1288 (1989) (noting that "complex regulatory issues are especially likely to be resolved in ways that benefit special interest groups").

205. *See supra* note 16.

206. Indeed, the ability of majority shareholders to lobby for lax provisions in substantive areas may well be one of the reasons why the real seat doctrine has been able to survive for so long.

207. At present, no less than 58% of U.S. public companies and no less than 59% of Fortune 500 companies are incorporated in Delaware. *See* Bebchuk & Hamdani, *Reconsidering the Competition*, *supra* note 186, at 578.

208. U.S. corporations are free, of course, to embrace codetermination voluntarily. *See* Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Law*, 102 YALE L.J. 2021, 2031 (1993).

result, organized labor in the United States has fewer incentives to lobby against flexible reincorporation rules than do its European counterparts. Furthermore, in the United States, the benefits of such rules are far less likely to be eliminated by pseudo-foreign corporation legislation than they are in Europe. Historically, the vast majority of U.S. states have failed to enact such legislation.[209] Moreover, and more importantly, there is little risk that pseudo-foreign corporation statutes might be applied to large, publicly-traded corporations. The dormant commerce clause, against which such statutes are measured,[210] requires a balancing of interests,[211] and a pseudo-foreign corporation statute's chances of passing constitutional scrutiny are much enhanced if it focuses on corporations of an essentially local nature, thereby minimizing the risk of subjecting corporations to conflicting legislation.[212] Indeed, the pseudo-foreign corporation statutes enacted by New York and California have been carefully designed to meet that requirement.[213] By contrast, there is no indication so far that the ECJ will require pseudo-foreign corporation statutes to be limited to corporations of a local nature.[214] Last but not least, the United States' traditional adherence to the state of incorporation

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209. Two notable exceptions are, of course, California and New York. *See* CAL. CORP. CODE § 2115 (West 1993 & Supp. 2004); N.Y. BUS. CORP. LAW §§ 1301-1319 (McKinney 2004).

210. *See, e.g.*, Deborah A. DeMott, *supra* note 3, at 183-90 (arguing that pseudo-foreign corporation statutes fail the balancing test required by the commerce clause); Stephen R. Ginger, *Regulation of Quasi-Foreign Corporations in California: Reflections on Section 2115 After* Wilson v. Louisiana-Pacific Resources, Inc., 14 SW. U. L. REV. 665, 672-83 (1984) (suggesting that California's pseudo-foreign corporation statute is incompatible with the commerce clause); Mark E. Kruse, Comment, *California's Statutory Attempt To Regulate Foreign Corporations: Will It Survive the Commerce Clause?*, 16 SAN DIEGO L. REV. 943, 952-65 (1979) (claiming that California's pseudo-foreign corporation statute violates the commerce clause).

211. *See, e.g.*, Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970); Kozyris, *supra* note 45, at 67-68.

212. *See* Wilson v. La.-Pac. Res., Inc., 138 Cal.App. 3d 216, 226 (1982) (noting that "[t]he potential for conflict and resulting uncertainty from California's statute is substantially minimized by the nature of the criteria specified in section 2115"). *See* Kozyris, *supra* note 45, at 67-68 (pointing out that New York's pseudo-foreign corporation statutes might "survive the balancing test of the commerce clause" because it does not overreach).

213. In particular, both the California and the New York Statute do not apply to corporations whose shares are traded on national exchanges. *See* CAL. CORP. CODE § 2115(c) (West 1993 & Supp. 2004); N.Y. BUS. CORP. LAW § 1320(a)(1) (McKinney 2004). In the literature, it has been surmised that this restriction is due, *inter alia*, to legal concerns. *See The Internal Affairs Doctrine*, *supra* note 2, at 1497 n.109 (noting that "[t]he California and New York legislatures must have feared that extending the statutes' coverage would be either ineffective or illegitimate").

214. Indeed, the opposite may well be the case. In *Centros*, the Court was faced with Danish rules on minimum capital requirements. The Court first pointed out that these rules, if applied to foreign corporations, constituted a restriction on the Freedom of Establishment. *See* Case 212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459, paras. 22, 30, [1999] 2 C.M.L.R. 551, 584, 586 (1999). It then asked whether they could be justified with a view to the protection of creditors. *See id.* paras. 31-32. However, it came to a negative conclusion, arguing *inter alia* that the rules in question where not suitable to achieve that aim. *See id.* para. 35. The Court noted that

> the practice in question is not such as to attain the objective of protecting creditors which it purports to pursue since, if the company concerned had conducted business in the United Kingdom, its branch would have been registered in Denmark, even though Danish creditors might have been equally exposed to risk.

Id. para. 35. In other words, the application of Denmark's minimum capital requirements to pseudo-foreign corporations could not be justified as a means of protecting creditors because such a course of action left creditors unprotected vis-à-vis truly foreign corporations. Obviously, that argument forces Member States to apply their corporate law both to pseudo-foreign and to truly foreign corporations in order to pass scrutiny under the Freedom of Establishment.

doctrine and the common character of reincorporation decisions ensure that any legislative effort to lower the standards for such decisions is likely to meet with exactly the lack of interest on the part of lawmakers and the public that interest groups hope for. Hence, the fact that the hurdles for reincorporation decisions are fairly low in the United States[215] does not imply that the same will be the case in the European Community.

All of these arguments may not convince true skeptics. In the long run, they may insist, there still is a risk that the rules governing reincorporation decisions will become lax enough in order for corporations to reincorporate in jurisdictions where minority shareholders can be exploited. Indeed, that prediction is hard to disprove because the Member States have never seriously experimented with free choice. But even if it were true that the Member States of the European Community will at some point lower the standards for reincorporation decisions to an extent that is perilous to the interests of minority shareholders, such a development still would not justify abandoning free choice. Rather, Community law could then impose minimum standards for reincorporation decisions, ensuring that the interests of minority shareholders are protected. Hence, however one looks at the situation, the more convincing view is that shareholder opportunism will not lead to a race to the bottom in European corporate law.

2. *State Competition*

Thus far, it has been argued that free choice will lead corporations to be governed by better law because corporations will tend to migrate to those states whose law maximizes shareholder value. Another question is whether states will actively seek to attract corporations, thereby engaging in a race for quality. In the literature, that question has frequently been answered in the negative.[216] European states, the argument runs, do not have sufficient incentives to compete for corporate charters because they cannot under Community law impose substantial franchise taxes on corporations that are domestic in name only.[217] Moreover some would argue that even if that prohibition did not exist, there would still be no incentive to compete because there is no Member State of the European Community for which franchise taxes could attain an importance similar to that which they have for Delaware.[218]

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215. *See supra* text accompanying notes 180-181.

216. *See* KIENIGER, WETTBEWERB, *supra* note 18, at 185-222; *see also* Holst, *supra* note 18, at 336 (arguing that "it is the desire for increased revenues from franchise taxes which drives American states to compete" and that "there is currently no corresponding financial incentive for European Member States to compete against one another"); Sørensen & Neville, *supra* note 9, at 208 (noting that "there are no fiscal advantages of becoming the Delaware of the European Union"). *But see* J. William Callison, *Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 IOWA J. CORP. L. 951, 981 n.188 (2001) (noting that "*Centros* . . . may begin the regulatory competition process for European business organization law"); KIENIGER, WETTBEWERB *supra* note 18, at 192 (suggesting that it is not completely impossible that legislators in Europe might compete for corporate charters).

217. *See, e.g.*, KIENINGER, WETTBEWERB, *supra* note 18, at 168, 185-87. *See also* ROMANO, GENIUS, *supra* note 7, at 133 (noting that European nations do not impose franchise taxes).

218. *See* KIENINGER, WETTBEWERB, *supra* note 18, at 192.

As regards the current law on franchise taxes, that reasoning is correct. Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital[219] makes it clear that only the real seat state can impose franchise taxes.[220] Nevertheless, the conclusion that European states will not compete for corporate charters seems on that basis alone premature. In fact, this Article comes to the opposite conclusion. If free choice were granted, European states would have strong incentives to compete for corporate charters even under the present legal system. Moreover, if the above-mentioned directive were abolished, franchise taxes could easily play a role similar to that in the United States.

a. *Incentives to Compete Other than Franchise Taxes*

Consider the incentives for states to compete for corporate charters under the present legal system. It goes without saying that such incentives will not exist until free choice is realized. After all, charter competition presupposes corporate mobility. If free choice were granted, however, the situation would look very different. As has long been recognized in the U.S. legal literature, one motive for states to compete for corporate charters may be the desire to generate business for local attorneys.[221] In the United States, the practical importance of this issue should not be overestimated. According to recent estimates by Kahan and Kamar, the additional revenues that Delaware lawyers received from charter competition in 2001 amounted to no more than $227 million.[222] Moreover, Kahan and Kamar predict that if another state were to gain a twenty percent share in the market for corporate charters, that state's lawyers would only gain about $90 million in additional revenue.[223] These figures seem comparatively small when one takes into account that during the same year, Delaware took in around $600 million in franchise taxes.[224] However, the relevant figures should not come as a surprise. It has

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219. Council Directive 69/335/EEC, 1960 O.J. (L 249) 25.

220. *See id.* art. 2(1) ("Transactions subject to capital duty shall only be taxable in the Member State in whose territory the effective centre of management of a capital company is situated at the time when such transactions take place.") Regarding the notion of "capital company," Article 3(1) not only contains an exhaustive list of organizational forms used in the various Member States of the European Community—including for example, the German stock corporation—but also,more importantly, provides two auxiliary definitions that prevent the Member States from evading the relevant provisions by creating new organizational forms. *Id.* art. 3(1). According to Article 3(1)(b), "any company, firm, association or legal person the shares in whose capital or assets can be dealt in on a stock exchange" qualifies as a capital company. *Id.* art. 3(1)(b). The provision further extends the scope of that term by including "all companies, firms, associations or legal persons operating for profit whose members have the right to dispose of their shares to third parties without prior authorization and are only responsible for the debts" of the organization to the extent of their shares. *Id.* The transactions subject to "capital duty" are listed in Article 4 and include, *inter alia*, the formation of a company. *Id.* art. 4. The Court of Justice has made it clear that it does not matter, in this context, whether the relevant fees are charged once or on a regular basis. *See* Case C-178/91, Ponente Carni SpA v. Amministrazione delle Finanze, 1993 E.C.R. I-1915 paras. 30-32.

221. Bebchuk, *Desirable Limits*, *supra* note 6, at 1443; Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 771 (1995); Kahan & Kamar, *supra* note 182, at 694-700 (questioning the practical relevance of this factor).

222. Kahan & Kamar, *supra* note 182, at 697.

223. *Id.* at 698.

224. *See* U.S. CENSUS BUREAU, DELAWARE STATE GOVERNMENT TAX COLLECTIONS: 2001

long been pointed out that Delaware lawyers do not enjoy a monopoly as far as advice on Delaware law is concerned.[225] One need not, after all, be a member of the Delaware bar to give such advice,[226] and lawyers across the nation routinely specialize in Delaware law.[227] It is only in limited areas that corporations are forced to turn to Delaware law firms. Delaware law demands that court appearances and filings be made by lawyers admitted to the local bar.[228] In addition, firms chartered in Delaware must retain Delaware counsel to review their documentation each year.[229]

In the European Community, by contrast, the desire to generate—or preserve—business for local lawyers is likely to gain enormous importance. As a rule, a corporation's decision to reincorporate in another state will mean that its corporate law business will be lost to the lawyers of the real seat state, as the vast majority of European lawyers are only trained in their own state's corporate law. Moreover, there is little hope that this situation will change anytime soon because a number of factors make it far more difficult for European corporate lawyers to gain expertise in another state's corporate law than it is for their U.S. counterparts. First, of course, there are language barriers. Second, corporate law regimes in Europe are far less uniform than they are in the United States.[230] On central issues, such as the structure of the board[231] or the participation of employees in the management of the firm,[232] European corporate law regimes continue to exhibit widely different approaches. Third, and perhaps most importantly, a European lawyer cannot hope to provide competent legal counsel in the corporate law of another Member State simply because she has studied that particular area of the law. Corporate law constitutes only a fragment of a state's legal system, and the various European legal systems as a whole are divided by fundamental differences. For example, legal precedents are formally binding in common law countries but not in those Member States adhering to the civil law tradition.[233] As a result, attorneys from civil law countries may find it difficult to correctly assess the weight that is to be attached to existing case law under,

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(2002), http://www.census.gov/govs/statetax/0108destax.html.

225. *See* Macey & Miller, *supra* note 95, at 493.

226. *Id.*

227. *Id.*

228. *See* DEL. SUP. CT. R. 12; DEL. CH. CT. R. 170.

229. Macey & Miller, *supra* note 95, at 494.

230. *See* McCahery & Vermeulen, *supra* note 19, at 860-61.

231. Germany, Austria, the Netherlands, and the Scandinavian countries traditionally adhere to the two-tier board structure. By contrast, Greece, Ireland, Italy, Portugal, Spain, and the United Kingdom have a one-tier board structure like U.S. firms. Belgium and France have a mixed system under which both board structures are available. *See* Klaus J. Hopt, *The German Two-Tier Board: Experience, Theories, Reform*, *in* COMPARATIVE CORPORATE GOVERNANCE, *supra* note 187, at 228-29.

232. Several Member States, including Denmark, Germany, Luxembourg, the Netherlands, and Sweden, have adopted statutes that govern codetermination for employees in supervisory and management boards. *See* Gerum & Wagner, *supra* note 187, at 352.

233. *See, e.g.*, JOHN H. MERRYMAN, THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA 48-49 (2d ed. 1985). *See also* Nicolas Marie Kublicki, *An Overview of the French Legal System from an American Perspective*, 12 B.U. INT'L L.J. 58, 83-84 (1994) (pointing out that the doctrine of stare decisis is not part of the accepted rules of the French legal system); Tiziano Treu, *The Role of Neutrals in the Resolution of Shop Floor Disputes: Italy*, 9 COMP. LAB. L.J. 112, 123 (1987) (noting that although in Italy precedents are not binding, lower courts are likely to follow decisions of the Corte di Cassazione).

for example, U.K. law. From these considerations, it follows that the lawyers of each Member State will, for decades to come, enjoy a de facto monopoly where legal advice on the finer points of their own state's corporate law is concerned. To be sure, there will be exceptions to this rule. Member States such as Germany and Austria have corporate law systems that are fairly similar and are not divided by language barriers. However, these exceptions do not change the overall picture painted above.

The economic importance of the issue at hand can hardly be overstated. According to recent estimates for the year 2001, the gross revenue per attorney in the twenty leading German law firms varied between €218,000 and €648,000; those per equity partner ranged from €680,000 to €3,100, 000.[234] These sums are rather modest by U.S. standards, but if one considers the numbers of lawyers involved in the practice of corporate law, it becomes clear that the sums involved are staggering. One example may serve to illustrate this point. The Frankfurt office of Clifford Chance alone has about 23 partners specializing in corporate law.[235] With estimated revenues per partner averaging €3.1 million,[236] revenues from the firm's corporate law business add up to €71.3 million (around $87.8 million). In light of the sums involved, it seems reasonable to assume that even if the Member States of the European Community were to compete only with a view to procuring business for the local bar, they would nevertheless compete quite as vigorously as do states in the United States.

To be sure, two objections may be raised in this context. First, even if the local bar in the real seat state were to lose much of its business to law firms from other states, the real seat state's tax revenues will not necessarily suffer accordingly. After all, in order to give legal advice to firms from other Member States, law firms from the more popular states of incorporation will have to open branch offices in other states. The revenues gained by these branch offices, however, would be taxed in the state where the branch office is located.[237] That means that the real seat state's fiscal incentive to generate business for local lawyers may not be as substantial as the numbers above

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234. *See* Aled Griffiths, *Die Entzweiung des Marktes* [*Dividing the Market*], JUVE RECHTSMARKT, Oct. 2002, at 8.

235. Clifford Chance, *Lawyers*, http://www.cliffordchance.de/uk/partners/index.shtml (last visited on Mar. 9, 2004).

236. *See* Griffiths, *supra* note 234.

237. Article 293(2) of the EC Treaty explicitly provides that "[t]he Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals . . . the abolition of double taxation within the Community." The Member States have accordingly entered into agreements to avoid double taxation. The relevant agreements all follow the OECD Model Tax Convention on Income and on Capital. *See* OTTO H. JACOBS, INTERNATIONALE UNTERNEHMENSBESTEUERUNG 68 (1999). According to art. 3(1)(c) of the Model Tax Convention, the term "enterprise" applies to the carrying on of any business and art. (3)(1)(h) makes it clear that the term "business" includes the performance of professional services. *See* ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL, art. 3 (Org. for Econ. Cooperation and Dev. 2003), http://www.oecd.org/dataoecd/52/34/1914467.pdf. Under Article 7(1) of the Convention, the profits of an enterprise of a contracting state shall be taxable only in that state. *Id.* art. 7(1). Furthermore, Article 7(2) of the Convention provides that "where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise." *Id.* art. 7(2).

suggest. However, even if one were to discount fiscal incentives completely, lawyers could still be expected to act as an interest group powerful enough to pressure their state to compete for corporate charters. Furthermore, it is unlikely that the real seat state's law firms would ever be completely shut out of the corporate law market. To gain access to clients, law firms from the more popular states of incorporation may decide to merge with or enter into alliances with law firms in other states. However, the terms of these mergers or alliances would reflect the value of the legal expertise of the lawyers in the more popular states of incorporation. Despite the aforementioned considerations, therefore, it seems safe to assume that lawmakers in the real seat state would be under considerable pressure to compete for corporate charters—if existing obstacles to corporate mobility were removed.

b. *Franchise Taxes*

Moreover, as a matter of legal policy, it does not seem justified to exclude franchise taxes as a motive for charter competition in the European Community. As explained above, such taxes cannot be imposed except by the real seat state. Given that the law of the European Community has to be modified anyway to guarantee free choice,[238] however, the relevant directive should not be regarded as the final word. After all, the competent Community institutions are free to issue a new directive that would allow such taxes. The interesting question is, of course, whether such a move would create a sufficient incentive to compete. As already mentioned, that question is often answered in the negative; it is asserted that states only have a significant financial incentive to compete if the relative importance of franchise fees as a source of income is sufficiently great.[239] No Member State of the European Community, it is argued, is likely to grow as dependent on franchise taxes as Delaware currently is.[240]

i. *Will Any Member State Have as Strong an Incentive To Compete as Delaware?*

It is helpful to start with the second part of that argument—the claim that no Member State is likely to grow as dependent on franchise taxes as Delaware currently is. In judging the relevance of this claim, several issues are important. First, there is the question of whether the European market for corporate charters will be as profitable as the U.S. market, thereby allowing the competing states to derive significant revenues from the chartering business. Second, there is the issue of whether there are Member States that are similar to Delaware in that their alternative sources of income are limited. Third, there is the question of whether such Member States can be expected to gain a significant share of the market for corporate charters. As shown below, all of these questions have to be answered in the affirmative.

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238. *See supra* Sections II.A.-B.
239. *See, e.g.*, KIENINGER, WETTBEWERB, *supra* note 18, at 191.
240. *Id.*

(1) *Will Any Member State Derive Considerable Revenues from the Chartering Business?*

There is reason to believe that the European market for corporate charters will not be substantially less lucrative than the U.S. market. The combined GDP of the European Community is roughly comparable to that of the United States. In 2001, the U.S. GDP amounted to $10.1 trillion.[241] In the same period, the combined GDP of the Member States of the European Community added up to €8.8 trillion, around $7.9 trillion at then-prevailing exchange rates.[242] This difference can hardly be deemed substantial enough to doubt the relevance of the European market for corporate charters.

Admittedly, Europe's GDP is only a very imprecise indicator of how profitable the European charter market is likely to be. A great deal depends on whether European corporations will be as willing as their U.S. counterparts to pay for efficient corporate law. Three arguments might be advanced to justify a negative answer.

First, one may point to the fact that because of the various practical obstacles to corporate mobility described in Part II, European corporations will simply not be as willing as their U.S. counterparts to reincorporate in other states. Consequently, they will also be less willing to pay for the privilege of incorporating in another jurisdiction. While that argument may have a certain appeal at first glance, its merits must be questioned. Admittedly, European corporations will find it more burdensome than their U.S. counterparts to reincorporate in another state. However, many of the relevant obstacles—exposure to litigation, language barriers, the cost of changing one's lawyer, conflicts of interest on the part of corporate lawyers—are far less problematic with regard to large, publicly traded corporations than with regard to closely-held corporations. Given that the latter tend to incorporate in their real seat state even in the United States,[243] any lack of mobility that close corporations may show in the European context is unlikely to make the European charter market much less profitable than the U.S. market.

Moreover, it does not even seem certain that European corporations, be they publicly traded or closely held, will be less mobile than their U.S. counterparts. To be sure, European corporations willing to reincorporate face more obstacles. However, the potential upside to those firms that decide to reincorporate is also far greater than that of U.S. corporations for the simple reason that corporate law in the United States is relatively uniform across states.[244] States hoping to attract corporate charters have to rely on

241. The World Bank Group, *Data by Country*, http://www.worldbank.org/data/countrydata/countrydata.html (last visited Mar. 9, 2004).

242. EUROPA, ECONOMIC PORTRAIT OF THE EUROPEAN UNION 2002, at 8 (2002), http://europa.eu.int/comm/eurostat/Public/datashop/print-catalogue/EN?catalogue=Eurostat&theme=2-Economy%20and%20Finance&product=KS-AI-02-001-__-N-EN (last accessed Apr. 2, 2004). These figures are, of course, pre-enlargement.

243. *See supra* note 158.

244. *See, e.g.*, Coffee, *supra* note 169, at 702 (noting that "a high degree of uniformity has

"secondary" factors including the amount and quality of existing case law,[245] the likelihood of the state's future responsiveness to corporate needs,[246] and the proficiency of the state's court system.[247] European states are free to compete on these auxiliary issues, but they also offer substantive rules that differ more widely from one state to another. That these differences matter greatly to corporations is illustrated by the facts underlying *Centros*. In that case, a Danish couple went through all the trouble of forming a U.K. company for the sole purpose of avoiding the Danish minimum capital requirements.[248] One may reasonably expect larger corporations to evince even more enthusiasm for avoiding rules that they find burdensome, including the German rules on codetermination. Empirical evidence tends to support the prediction that many corporations will flee their real seat state. France, for example, introduced the real seat rule in the nineteenth century, precisely because incorporation in the United Kingdom and in Switzerland was becoming the norm.[249] Similarly, the recent adoption of a pseudo-foreign corporation statute in the Netherlands[250] should be seen in the context of the large numbers of Dutch businesses that were incorporating abroad to avoid the

emerged in American corporate laws"); Romano, *The State Competition Debate*, *supra* note 52, at 709 (noting "substantial uniformity across the states").

245. A number of scholars have noted that Delaware's rich body of precedents is an important factor in attracting foreign corporations. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 213 (1991) (listing Delaware's "large body of precedents" as one of the three main reasons for that state's success in the market for corporate charters); ROMANO, GENIUS, *supra* note 7, at 39 (noting Delaware's large body of case law as one of the advantages of Delaware corporate law); Eisenberg, *supra* note 161, at 1511 (describing "a rich body of case-law that facilitates planning and dispute-settlement" as one of the attractions of Delaware law).

246. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 245, at 213 (noting that Delaware's "credible commitment to be receptive to corporate needs" is one of the main factors allowing Delaware to dominate the charter market); ROMANO, GENIUS, *supra* note 7, at 37-44 (stressing the role of Delaware's commitment to future responsiveness in explaining that state's success in the market for corporate charters).

247. *See* ROMANO, GENIUS, *supra* note 7, at 40 (pointing to the expertise of Delaware's judiciary in corporate matters); Black, *supra* note 52, at 590 (claiming that the expertise of Delaware's judges is the primary reason behind Delaware's success in the chartering market).

248. Mr. and Mrs. Bryde never actually admitted any intention to circumvent Danish law, but Mr. Bryde conceded that "it is certainly easier to find £100 than 200,000 Dkr." *See* Case 212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459, para. 3, [1999] 2 C.M.L.R. 551, 557 (1999) (opinion of Advocate General La Pergola).

249. *See* Bernhard Großfeld, *Die Entwicklung der Anerkennungstheorien im internationalen Gesellschaftsrecht* [*The Development of the Theories on the Recognition of Foreign Legal Persons in the Corporate Conflict of Laws*], *in* FESTSCHRIFT FÜR HARRY WESTERMANN 199, 208-09 (Wolfgang Hefermehl et al. eds, 1974) (noting that it became fashionable for French corporations in the second half of the 19th century to incorporate in the United Kingdom or in Switzerland and that this trend was the decisive reason for the triumph of the real seat doctrine in French law).

250. Wet van 17 december 1997, houdende regels met betrekking tot naar buitenlands recht opgerichte, rechtspersoonlijkheid bezittende kapitaalvennootschappen die hun werkzaamheid geheel of nagenoeg geheel in Nederland verrichten en geen werkelijke band hebben met de staat naar welks recht zij zijn opgericht (Wet op de formeel buitenlandse vennootschappen) [Law of December 17, 1997 including various rules regarding capital companies formed under foreign law and having a legal personality, which exercise all or most of their activities in the Netherlands and do not have an actual connection with the state under the law of which they were formed (law on formally foreign companies)], Stb. 1997, 697 (Neth.). In a very recent decision, the ECJ has found the relevant statute to be in violation of the Freedom of Establishment. *See* Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd, 24 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 1885, 1893 para. 142 (2003). *See also supra* text accompanying notes 39-43.

Dutch minimum capital requirements.[251] In sum, therefore, it does not seem justified to cite a lack of mobility on the part of corporations as a reason why the European charter market should be less profitable than the U.S. market.

Romano has suggested two other reasons why European corporations may be less willing than their U.S. counterparts to pay for efficient corporate law. She points out that stock ownership tends to be far more concentrated in Europe than it is in the United States[252] and that relatively few European corporations are publicly traded.[253] These differences, she argues, are not without relevance to the charter market. First, according to Romano, differences in corporate law regimes are not as important to privately held firms as they are to publicly held firms. That is because in the former, the owners can control the firm without serious constraint, reducing the agency problems between managers and shareholders.[254] Second, she points out that because many corporations are not publicly traded, a key feedback mechanism that provides investors with information and drives state competition is missing in the European context.[255]

Yet, contrary to what Romano suggests, the prevalence of concentrated ownership and the relatively small number of publicly traded companies do not really help to explain the lack of a market for corporate charters in Europe. Concentrated ownership surely serves to reduce principal-agent problems between managers and shareholders. That does not mean, however, that corporate law regimes are less important to such corporations. Where conflicts of interests between shareholders and managers are missing, other conflicts of interest take their place. German corporate law, for example, has traditionally focused on conflicts between majority shareholders and minority shareholders[256] precisely because concentrated ownership is the rule in Germany.[257]

Moreover, there is little reason to believe that corporations will be less interested in efficient corporate law rules simply because they are not publicly

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251. *See* Stephan Rammeloo, *Recognition of Foreign Companies in "Incorporation" Countries: A Dutch Perspective, in* CURRENT ISSUES OF CROSS-BORDER ESTABLISHMENT OF COMPANIES IN THE EUROPEAN UNION 47, 58-60 (Jan Wouters & Hildegard Schneider eds., 1995).

252. ROMANO, GENIUS, *supra* note 7, at 136.

253. *Id.* at 138.

254. *Id.* at 138.

255. *Id. See also* McCahery & Vermeulen, *supra* note 19, at 863 (noting that "European patterns of corporate regulation and equity capitalization do not open market opportunities for revenue-seeking jurisdictions").

256. *See, e.g.*, Franz-Jörg Semler, *§ 41: Mängel der Beschlüsse und Wahlen [§ 41: Defective Resolutions and Elections]*, *in* 4 MÜNCHENER HANDBUCH DES GESELLSCHAFTSRECHTS: AKTIENGESELLSCHAFT 559 (Michael Hoffmann-Becking ed., 2d ed. 1999) (pointing out that under German law, majority shareholders must not abuse their power vis-à-vis minority shareholders and arguing that this principle can be derived from fiduciary duties, the principle of good faith, or a general doctrine of abuse of rights). It should also be pointed out that German corporate law contains detailed rules on the law of corporate groups, the so-called Konzernrecht, which—*inter alia*—seeks to protect minority shareholders. *See, e.g.*, Maximilian Schiessl, *The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries Under German Law*, 7 NW. J. INT'L L. & BUS. 480, 483-84 (1986).

257. *See* Mark J. Roe, *supra* note 188, at 254 (categorizing Germany as a country with concentrated ownership); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 492 (1999) (giving an overview of the concentration of ownership in various countries).

traded. After all, stock prices are not the only mechanism conveying information to investors, and owners of privately held firms are no less well-positioned than the shareholders of publicly held firms to judge whether the company they own should be more profitable. Indeed, as Romano herself points out, one of the reasons that many European corporations are not publicly traded lies precisely in the desire to avoid the more onerous regulation that the Member States impose on public corporations.[258] Differences in market capitalization and stock ownership matters, therefore, do not justify the claim that European corporations will be less willing to pay for efficient corporate law rules than their U.S. counterparts. Overall, there is no reason to believe that there is far less money to be made in the European market for corporate charters than in the U.S. market.

(2) *Are There Member States Whose Other Sources of Income Are Limited?*

Another question is whether any Member State of the European Community is comparable to Delaware in that the revenues from franchise fees might become an important source of revenues in relative terms. If one looks only at the budgets of those countries that are presently part of the European Community, that question may seem to warrant a negative answer. In 2000, Delaware collected taxes in the overall amount of $2.1 billion.[259] The Member State of the European Community that came closest to that figure is Luxembourg. But even Luxembourg, by far the smallest Member State, had total tax revenues of €5.7 billion (about $5.4 billion) in 2000—almost three times as much as Delaware.[260]

However, these numbers are misleading. A comparison between a state's income from franchise fees and its total tax revenues is only one measure of financial dependence on the charter market. After all, the fact that a country spends more and hence imposes more taxes in addition to franchise fees does not mean that the country can more easily afford to forego income from franchise taxes. Consequently, it may be more telling to look at a country's GDP (or a state's GSP), which provides an idea of the extent of the economic activity that the country or state could tax if need arose. When that figure is used, however, the situation between Delaware and Luxembourg is reversed. In 2000, Delaware had a gross state product of $36.3 billion, while Luxembourg's gross domestic product amounted only to $18.9 billion. Indeed, if the total amount of GDP is considered, a number of other EU Member States also emerge as possible competitors in the market for corporate charters. Ireland, Greece, and Portugal, for example, all have GDPs that are less than three times as large as Delaware's.[261]

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258. ROMANO, GENIUS, *supra* note 7, at 139.

259. U.S. CENSUS BUREAU, DELAWARE STATE GOVERNMENT TAX COLLECTIONS: 2001 (rev. 2002), http://www.census.gov/govs/statetax/0108destax.html (last visited Mar. 9, 2004).

260. SERVICE CENTRAL DE LA STATISTIQUE ET DES ETUDES ECONOMIQUES LUXEMBOURG (STATEC), LE LUXEMBOURG EN CHIFFRES, http://www.statec.lu/html_fr/statistiques/luxembourg_en_chiffres/index.html (last visited Mar. 9, 2004).

261. BUREAU OF ECONOMIC ANALYSIS, U.S. DEPARTMENT OF COMMERCE, REGIONAL

TABLE 1. GROSS DOMESTIC/STATE PRODUCTS FOR CORPORATE CHARTER COMPETITORS, 2000-2001

State	Delaware	Luxemburg	Ireland	Portugal	Greece
2000 GDP/GSP (in billions of dollars)	36.3	18.9	93.0	105.1	112.6
2001 GDP/GSP (in billions of dollars)	40.5	19.8	101.2	108.5	116.3

The situation changes again when one considers some of the new Member States that are set to join the European Community in 2004. With the exception of the Czech Republic, Hungary, and Poland, the accession countries' GDPs are consistently smaller than Delaware's GSP.[262] In the case of Malta, the GDP is only about one-tenth of the GSP of Delaware.

TABLE 2. GROSS DOMESTIC PRODUCTS FOR NEW EC MEMBER STATES, 2000-2001

State	Estonia	Latvia	Lithuania	Malta	Slovenia
2000 GDP (in billions of dollars)	5.0	7.2	11.3	3.3	18.1
2001 GDP (in billions of dollars)	5.3	7.5	11.8	3.6	18.8

State	Hungary	Cyprus	Czech Rep.	Poland	Slovak Rep.
2000 GDP (in billions of dollars)	45.6	8.5	50.8	157.6	19.1
2001 GDP (in billions of dollars)	52.4	8.7	56.4	174.6	19.5

Admittedly, these countries would have other barriers to overcome before they could hope to attract a large number of foreign corporations. Most importantly, the judicial systems in some of the future Member States may not yet inspire the necessary confidence among foreign investors. However, that obstacle is not insurmountable. In sum, therefore, there are likely to be quite a

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ECONOMIC ACCOUNTS, GROSS STATE PRODUCT, http://www.bea.doc.gov/bea/regional/gsp.htm (last visited Apr. 27, 2004); THE WORLD BANK GROUP, DATA AND STATISTICS, DATA BY COUNTRY, http://www.worldbank.org/data/countrydata/countrydata.html [hereinafter WORLD BANK GROUP] (last visited Mar. 9, 2004).

262. WORLD BANK GROUP, *supra* note 261.

few Member States for whom the relative importance of the revenues derived from the chartering business will be as great as it is for Delaware.

(3) *Will Corporations Concentrate on States for Which Franchise Fees Matter?*

If corporations were to remain scattered evenly across the European Community, one might fear that no state would be able to become sufficiently dependent on the chartering for franchise fees to create a strong incentive to compete. The likelihood of this outcome is, however, quite low. European corporations faced with the prospect of free choice are likely to reincorporate in one or a few Member States, and it is highly probable that one or more of the smaller Member States will emerge as the leading jurisdiction(s).

In fact, corporations would very likely concentrate on one or a few Member States, even if the Member States did not actively compete for corporate charters. The reasons are simple. Given the differences between European corporate law regimes, it is unlikely that corporations will find all corporate law regimes equally efficient. Moreover, it has already been mentioned that the proficiency of national court systems varies greatly.[263] Therein lies a powerful incentive to reincorporate. It is extremely hard to imagine, for example, that large Italian corporations will put up with the endless delays imposed by Italy's court system if they can avoid the relevant problems simply by reincorporating in another Member State.[264] Once corporations start migrating towards one or more jurisdictions, the relevant Member States will profit from network effects that make their law even more attractive. As Michael Klausner has pointed out, there are considerable advantages to being incorporated in a state where many other corporations are incorporated.[265] For one, the state's case law will grow with the number of corporate charters.[266] Moreover, the judges of the leading state of incorporation will tend to acquire greater expertise in corporate law matters, because they will handle more of the relevant cases.[267] Last but not least, investors and third-party creditors will find it easier to evaluate the rules governing the corporation's internal affairs if the corporation is incorporated in a popular state of incorporation. Thus, once a state has an edge in the market for corporate charters, theory predicts that the gap between the market leader and the remaining states is likely to increase.

Against this background, therefore, the only question is whether the market leader will be one of the smaller Member States, for which franchise

263. *See supra* note 121 and accompanying text.

264. *See supra* note 121.

265. *See* Klausner, *supra* note 221, at 842-47 (describing network benefits enjoyed by corporations incorporated in popular states of incorporation).

266. *See id.* (categorizing the relevant benefits as "interpretative network externalities" and suggesting that they increase the value of Delaware law).

267. *Id.* Of course, the fact that the expertise of Delaware's judges is due to specialization has been known long before the issue of network effects was introduced into the debate on charter competition. *See, e.g.*, Black, *supra* note 52, at 589.

fees matter enough to represent a significant incentive to compete. Once again, the answer is probably yes. For various reasons, small states are in a better position to compete for corporate charters than are big states. As Romano has pointed out, a state's financial dependence on chartering fees increases the state's attractiveness as a legal home to corporations,[268] and smaller states have a natural advantage when it comes to cultivating their own dependence on the chartering business. Moreover, the legislature of a small state can focus on the interests of shareholders (and managers) without having to worry too much about other political constituencies such as employees.[269] In addition, the legislature of a small state can allow itself to focus more of its time on corporate law, once that area has gained a certain importance for the state's budget. Thus, small states will find it easier to modernize their corporate law in a timely fashion.

Yet even more important than these factors may be the advantage that small states enjoy when it comes to offering a proficient court system. As has often been noted, the existence of a highly proficient court system plays an important role in attracting corporate charters.[270] Corporations will naturally prefer states that can provide speedy trials and judges specialized in corporate law. When it comes to setting up such court systems, small states enjoy a tremendous edge. As Kahan and Kamar have noted, there can be political obstacles to setting up courts that only have jurisdiction to hear corporate law matters.[271] Indeed, the population in general may not tolerate corporations having access to speedy trials and expert judges when everyone else must settle for judicial services of average quality. The important point to make in this context—and one that Kahan and Kamar fail to see—is that small states can avoid this problem more easily than can large states. Small states need not introduce a formal distinction between corporate law and other legal matters in order to be able to offer specialized courts and speedy trials. Instead, they can simply raise the quality of their court system as a whole, knowing that the number of non-corporate law cases will be limited anyway. The Delaware Court system may serve to illustrate this point. Delaware's Chancery Court has jurisdiction to hear and determine all matters and causes in equity,[272] including trusts and estates, other fiduciary matters, disputes involving the sale of land, questions of title to real estate, and commercial and contractual matters in general.[273] However, in practice, around three-quarters of the court's pending cases are in the field of corporate law.[274]

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268. Romano, *Law as a Product*, *supra* note 5, at 280-81; Romano, *The State Competition Debate*, *supra* note 52, at 721. Many other scholars have endorsed this view. *See, e.g.*, Larry Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999, 1012 (1994).

269. In the U.S. literature, this factor is often mentioned as one of the advantages enjoyed by Delaware. *See, e.g.*, William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 306-08, 326 (1997); Macey & Miller, *supra* note 95, at 490.

270. *See supra* note 247.

271. Kahan & Kamar, *supra* note 182, at 731-35 (suggesting that political constraints have played a major role in the decision of U.S. states not to copy Delaware's law or to set up a court specialized in corporate law matters).

272. DEL. CODE ANN. tit. 10, § 341 (2002).

273. *See* ADMINISTRATIVE OFFICE OF THE COURTS, 2002 STATISTICAL REPORT OF THE DELAWARE JUDICIARY: JUSTICE ON THE MOVE 23, http://courts.state.de.us/Courts/Supreme%20Court

In any case, even an approach that openly discriminates between corporate and other matters would be far easier to defend politically in a small state than in a larger state, especially where the former has grown dependent on the chartering business. Delaware's voters are unlikely to balk at the preferential treatment of corporations, because they know—or at least can be told—that such preferential treatment allows the state to reap immense benefits from the charter market, reducing the need to tax the state's natural citizens. By contrast, the population of a large state is less likely to heed such arguments, given that big states can only derive a relatively small part of their revenues from the chartering business. In sum, therefore, there is reason to believe that one of the smaller Member States of the European Community will likely end up dominating the market for corporate charters simply because smaller states enjoy certain natural advantages in the market for corporate charters.

It should also be noted that no Member State is likely to dominate the market for corporate charters without competing actively. Any state—large or small—interested in establishing itself as an attractive destination for firms looking to reincorporate must make a substantial investment in its legal and judicial services. This investment could manifest itself in a variety of ways, one of which would be to provide these services in several languages. Article 4 of the Swiss Law on Federal Civil Procedure, for example, provides that the judge and the parties have to use one of the national languages of Switzerland,[275] i.e., German, French, Italian, or Romansh.[276] A non-multilingual Member State will only be willing to shoulder the burden of providing its legal services in several languages, however, if it seeks to attract foreign corporations. Alternatively, a state could set up a court system offering particularly speedy proceedings and staffed with highly-qualified experts. The only certainty is that success in the European market for corporate charters is unlikely to come without effort. To be sure, a Member State may gain a lead in the market for charters without taking the above-described steps. However, as long as the leading state of incorporation does not compete actively for corporate charters, other states have an incentive to step in. No Member State, therefore, is likely to retain the lead in the European market for corporate charters without devoting considerable resources to achieving this aim.

In sum, there is every reason to believe that the Member States of the European Community will compete actively for corporate charters. Given that European corporations will probably tend to reincorporate in those

/2002%20Annual%20Report/?2002Final.pdf (last visited Mar. 9, 2004).

274. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 903 (1990).

275. *See* Bundesgesetz über den Bundeszivilprozess, Loi fédérale de procédure civile fédérale, Legge di procedura civile federale, art. 4, Dec. 4, 1947, SR 273 (Switz.)("Der Richter und die Parteien haben sich einer der Nationalsprachen des Bundes zu bedienen. Nötigenfalls ordnet der Richter Übersetzung an. [The judge and the parties have to use one of the national languages of the Federation. If necessary, the judge orders translation.]").

276. *See* BUNDESVERFASSUNG, CONSTITUTION FÉDÉRALE, COSTITUZIONE FEDERALE [Constitution] art. 4 (Switz.).

jurisdictions that offer the most efficient corporate law, such competition will most likely result in a race for quality.

3. *Federal Influence*

To compare the hypothetical outcome of harmonization to the hypothetical outcome of free choice, one needs to consider yet another issue: the fact that the legislative process at the state level may well be influenced by the desire to avoid federal intervention. In the U.S. legal literature, it has long been acknowledged that preventing the federalization of corporate law may be one of the forces shaping Delaware legislation and case law.[277] Mark Roe has presented a particularly radical version of this thesis.[278] According to Roe, the content of U.S. corporate law rules is, for the most part, decided at the federal level.[279] In support of this claim, Roe points out that the federal government influences the shape of corporate law in two ways. First, the federal government preempts those Delaware rules that it finds intolerable.[280] Thus, the remaining rules can only on a formal level be attributed to Delaware; they exist because they have been approved—or at least not been disapproved too strongly—by the federal government.[281] Roe also stresses the above-mentioned desire on the part of Delaware lawmakers to avoid the federalization of corporate law.[282] In combination, Roe argues, these two factors ensure that corporate law is "87.5% federal."[283] According to Roe, "Delaware gets to say the words, but only as long as the federal authorities tolerate its script."[284]

This Article does not seek to verify or refute Roe's claim with regard to U.S. corporate law.[285] Rather, the question to be asked in the present context

277. *See supra* note 161.

278. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

279. *Id.* at 601 (suggesting that "corporate law in this setting can be seen as up to 87.5% federal").

280. *Id.* at 607-34 (describing various federal interventions in the field of corporate law).

281. *Id.* at 644 ("What remains with the states is the corporate law that the Federal players tolerate, and what gets reversed is that which they do not.").

282. *Id.* at 601-07.

283. *See id.* at 601.

284. *Id.*

285. Nevertheless, it should be noted that Roe's thesis faces at least one problem: how can Delaware maintain its lead in the market for corporate charters if Delaware's law is shaped by the threat of federal intervention rather than by market forces? After all, states other than Delaware usually derive few revenues from charter competition. Hence, the threat of federalization is hardly suitable to discourage them from adopting whatever laws they wish. In other words, other states can do what Delaware according to Roe's model is prevented from doing: they can offer a corporate law regime that is designed to attract as many corporate charters as possible. If Delaware law were substantially shaped by the threat of federal intervention, then one has to wonder why other states do not manage to attract more corporate charters by offering rules more adapted to corporate preferences. One could, of course, point to Delaware's other advantages in order to explain why Delaware is able to maintain its lead even though its rules are indirectly shaped by the federal legislator. Yet some skepticism seems in order: Romano's commitment theory—which argues that the central advantage Delaware holds in the market for corporate charters results from the fact that Delaware is financially dependent on franchise fees and thus can be relied on to maintain the high quality of its corporate law in order to attract corporations—no longer works if the content of Delaware's law is decided in Washington and Delaware's ability to control such law is thereby limited. That leaves Delaware's judiciary and its rich body of case law. However, while these factors seem of paramount importance where substantive corporate law rules are

are whether if corporate law in the European Community is not harmonized, to what extent will its shape be influenced by the threat of harmonization? Moreover, how does this factor affect the desirability of harmonization in the Community?[286]

The answer to the first question is straightforward: while the threat of federal intervention may be significant in the United States, it is likely of little importance in the European Community. As a rule, the preconditions for legal harmonization are too restrictive for such a threat to be credible. The main basis for Community legislation aiming at harmonizing corporate law is Article 44(2)(g) of the EC Treaty:

> The Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular: . . . (g) by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and other [sic], are required by Member States of companies or firms within the meaning of the second paragraph of Article 48 with a view to making such safeguards equivalent throughout the Community.[287]

The requirements that have to be met in order for such legislation to be adopted are strict. Article 44(1) of the EC Treaty refers to the procedure described in Article 251.[288] The latter provision requires, inter alia, a qualified majority in the Council, where the governments of the Member States are represented.[289] The notion of a qualified majority is defined in Article 205(2)—each Member State has a certain number of votes and there are eighty-seven votes overall.[290] A qualified majority requires no less than sixty-two votes.[291] The difficulty of meeting this target becomes clear as one considers the allocation of votes. Each of the so-called "big" Member States—Germany, France, Italy, and the United Kingdom—has ten votes.[292] Hence, a qualified majority cannot be reached if, out of the pre-enlargement fifteen Member States of the European Community, as few as two of the big Member States and at least one of the smaller ones cast a negative vote. Against this background, state legislators will rarely cave in to pressure from the European Community.

In any case, even if the Member States were influenced by the prospect of federal intervention, the question would remain whether that influence

equally efficient, it seems questionable whether they can explain the popularity of Delaware law if one assumes that Delaware's substantive rules suffer from serious shortcomings.

286. Roe also addresses the relevance of his thesis to European corporate law. *See* Roe, *supra* note 278, at 644 (pointing out that "[i]f European policymakers want to create an EU structure parallel to America's, Brussels must . . . be as likely or unlikely to make EU-wide corporate law as Washington is to make federal corporate law"). However, he does not analyze the question of whether Brussels is in fact any more likely to intervene than Washington.

287. EC TREATY art. 44(2).

288. EC TREATY art. 44(1) ("In order to attain freedom of establishment as regards a particular activity, the Council, acting in accordance with the procedure referred to in Article 251 and after consulting the Economic and Social Committee, shall act by means of directives.").

289. EC TREATY art. 203 ("The Council shall consist of a representative of each Member State at ministerial level, authorised to commit the government of that Member State.").

290. EC TREATY art. 205(2).

291. EC TREATY art. 205(2) ("For their adoption, acts of the Council shall require at least . . . 62 votes in favour where this Treaty requires them to be adopted on a proposal from the Commission [or] . . . 62 votes in favour, cast by at least 10 members, in other cases.").

292. *Id.*

affects the desirability of harmonization. It seems reasonable to argue that any federal influence exerted on state legislation in the field of corporate law can only reduce, but not eliminate, the benefits of free choice. If state competition leads to more efficient rules than the Community legislative process, the outcome of free choice will be more efficient than harmonization as long as the Member States retain even the slightest leeway in shaping their own corporate law. To the extent that Member States feel free to deviate from the preferences of Community lawmakers, they will seek to implement solutions that correspond to corporate preferences. In sum, as long as Community law does not determine all aspects of state corporate law, the beneficial influence of state competition on corporate law will only be attenuated, but not eliminated.

All things considered, therefore, there is every reason to believe that free choice will lead corporations to be governed by more efficient corporate law rules than harmonization will.

B. *Legislative Costs*

In comparing the benefits and drawbacks of free choice to those of harmonization, it is also worth taking into account the legislative costs incurred by the creation and maintenance of a modern corporate law regime. At first glance, it may seem as though harmonization would be a viable option for reducing these costs—instead of a multitude of state legislatures grappling with similar issues, only one federal legislature, would need to undertake the relevant steps. Upon closer analysis, this argument is unconvincing.

First, the costs of parallel legislation in the Member States should not be overestimated. Legislators can largely delegate the task of designing rules to outsiders. The Delaware legislature, for example, has traditionally relied on drafting committees staffed with corporate attorneys.[293] Although such committees incur some costs, involvement in legislation has its own rewards, among them reputational advantages,[294] the satisfaction that comes from having influenced the content of legal rules, and access to information about the new rules. In addition, state legislators need not "reinvent the wheel" every time they modify their corporate law. They can simply rely on model codes or on codes enacted in other states in modernizing their corporate law.[295] As a result, the costs of maintaining a corporate law regime can be quite modest.

At the same time, one should not underestimate the costs of lawmaking at the Community level. Two factors need to be considered in this context.

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293. Macey & Miller, *supra* note 95, at 488-89; Cary, *supra* note 5, at 690.

294. *See* Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 145 (1996) (noting that the commissioners involved in the drafting of uniform state laws will receive reputational benefits).

295. This point is often mentioned as an argument why the costs of legislating should not prevent states from competing for corporate charters. *See, e.g.*, Kahan & Kamar, *supra* note 182, at 726 (noting that copying the Delaware code seems a viable strategy for states hoping to compete for corporate charter). *See also* Ayres, *Supply-Side Inefficiencies*, *supra* note 4, at 545 (noting that successful statutory solutions may be quickly copied by rival jurisdictions).

First, and most importantly, the decision-making process at the Community level directly involves the Member States. Regulations and directives have to be adopted by the Council,[296] which is composed of the representatives of the Member States.[297] As a result, the Member States will incur many of the same costs of decision-making that they would have had to bear in the absence of harmonization. Secondly, harmonization in the field of corporate law typically takes the form of directives rather than regulations.[298] Regulations are immediately binding upon citizens,[299] whereas directives only prescribe the requirements that the pertinent state rules have to meet, usually by specifying a particular content.[300] Thus, in the case of a directive, it is still up to the states to enact the relevant corporate law rules. Consequently, harmonization does not even avoid the costs associated with the formal measures of lawmaking. In sum, any cost savings that harmonization brings with regard to the legislative process are bound to be negligible at best.

C. *Economies of Scale and Network Benefits*

When the merits of legal harmonization are pondered, economies of scale and network benefits do not usually go unmentioned.[301] At first glance, such considerations seem to support the call for harmonization in the area of corporate law, as well. The application of a uniform corporate law regime appears to facilitate the generation of a rich body of precedents. If complete harmonization is achieved, all cases will be decided by applying the same corporate law regime. In addition, harmonization seems to promote the creation of a Community-wide market for legal and law-related services. Both of these ends seem consistent with encouraging economies of scale and network externalities. However, upon closer examination, both of the aforementioned advantages allegedly provided by harmonization prove illusory.

1. *The Generation of Legal Precedents*

Consider, first, the aim of securing the creation of a comprehensive body of case law. Under free choice, the creation of a comprehensive and coherent

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296. *See* EC TREATY arts. 251, 252.

297. *See* EC TREATY art. 203 ("The Council shall consist of a representative of each Member State at ministerial level, authorized to commit the government of that Member State.").

298. For an overview of the various directives on company law, see VANESSA EDWARDS, EC COMPANY LAW (1999).

299. *See* EC TREATY art. 249 ("A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States.").

300. *See* EC TREATY art. 249 ("A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.").

301. *See* Daniel C. Esty, *Revitalizing Environmental Federalism*, 95 MICH. L. REV. 570, 618 (1996) (noting that in the area of environmental law, harmonization across jurisdictions can create important economies of scale); Holst, *supra* note 18, at 338 (arguing that harmonization "saves decisionmakers and transactors the costs of having to develop and learn a multiplicity of rules" while conceding that "presumably in the EU as in the U.S. harmonizing legislation would never completely preempt the laws of individual states and therefore more than one body of law would survive").

body of precedents in at least one jurisdiction is highly likely. As mentioned above, it is to be expected that European corporations will concentrate on one or a few Member States.[302] Even under free choice, therefore, many cases will be decided under the same corporate law regime. Moreover, given that corporations will tend to incorporate in states whose judiciaries are particularly proficient, the quality of the resulting precedents will be comparatively high.

By contrast, harmonization is not likely to create a similarly large number of precedents. Nor can the case law generated by harmonization be expected to be of an exceptional quality. The reasons for this stem from the structure of the European judiciary as specified in the EC Treaty and in the Statute of the Court.[303] According to the relevant provisions, the European Community has only two courts, the ECJ and the Court of First Instance. Neither of these two courts has original jurisdiction in proceedings between private parties.[304] Rather, such proceedings must always be first brought in the courts of the Member States. The ECJ can only become involved in corporate law cases in an indirect fashion. If the decision of the national court depends on an interpretation of EC law, Article 234 of the EC Treaty authorizes—and under certain circumstances obliges—the national court to request a preliminary ruling by the ECJ.[305] Even then, however, the ECJ only rules on the correct interpretation of Community law. By contrast, the finding of the relevant facts and the application of Community law to the facts are left to the national court.[306] Under this system, precedents can be created either by the ECJ or by the courts of the Member States.

a. *The Court of Justice of the European Communities*

The ECJ is ill-equipped to create a large and coherent body of case law in the corporate law context, primarily because it is notoriously overloaded with cases.[307] As a result, the preliminary rulings procedure in particular is

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302. *See supra* text accompanying notes 267-274.

303. *See* EC TREATY art. 311 ("The protocols annexed to this Treaty by common accord of the Member States shall form an integral part thereof.").

304. *See* EC TREATY arts. 226-39 (regulating the jurisdiction of the ECJ); EC TREATY art. 225 (describing the role of the Court of First Instance).

305. Article 234 of the EC Treaty, reads:

> The Court of Justice shall have jurisdiction to give preliminary rulings concerning: (a) the interpretation of this Treaty; (b) the validity and interpretation of acts of the institutions of the Community and of the ECB; (c) the interpretation of the statutes of bodies established by an act of the Council, where those statutes so provide. Where such a question is raised before any court or tribunal of a Member State, that court or tribunal may, if it considers that a decision on the question is necessary to enable it to give judgment, request the Court of Justice to give a ruling thereon. Where any such question is raised in a case pending before a court or tribunal of a Member State against whose decisions there is no judicial remedy under national law, that court or tribunal shall bring the matter before the Court of Justice.

EC TREATY art. 234.

306. *See, e.g.*, Case 13/68, Salgoil S.p.A. v. Italian Ministry of Foreign Trade, 1968 E.C.R. 453, 459, [1969] 1 C.M.L.R 181, 193 (1969) (noting that "Article 177 . . . does not give the Court jurisdiction to take cognizance of the facts of the case").

307. Ulrich Everling, *Die Zukunft der europäischen Gerichtsbarkeit in einer erweiterten Europäischen Union* [*The Future of the European Courts in an Enlarged European Union*], 32

extremely slow. In 1975, the average duration of a preliminary rulings procedure was about six months;[308] by the year 2000 that period had risen to 21 months.[309] That figure may not seem too impressive, when viewed in isolation, but the preliminary rulings procedure is only one element of the proceeding before state courts. The duration of the preliminary rulings procedure has to be added to the amount of time spent before the state court that requests the preliminary ruling. Against this background, it becomes clear that the delay imposed by the preliminary rulings procedure is considerable. Moreover, that delay is highly significant to the generation of case law. In case of substantial delays, some parties will undoubtedly be encouraged to resolve their conflicts by means other than formal legal proceedings.[310]

The aforementioned problems can be illustrated further by focusing on the number of corporate law cases that are decided by the Delaware judiciary on the one hand and by the Community judiciary on the other hand. In 2002, the Delaware Chancery Court decided 3,525 cases.[311] Given that around three-quarters of the cases decided by the Chancery Court are said to originate in the area of corporate law,[312] the total number of corporate law cases decided by the Delaware judiciary in 2002 was approximately 2,644. By contrast, in 2002 the Court of First Instance decided a total of 314 cases,[313] four of which pertained to the area of corporate law.[314] In the same year, the ECJ decided a total of 360 cases,[315] ten of which concerned the area of corporate law.[316] In summary, the structure of the ECJ hardly allows for the kind of specialization on which the excellence of Delaware judges is founded.

EUROPARECHT 398, 401-02 (1997) (stressing that the ECJ is overloaded with cases); *see also* Burkhard Hess, *Rechtsfragen des Vorabentscheidungsverfahrens [Legal Issues Concerning the Preliminary Rulings Procedure]*, 66 RABELS ZEITSCHRIFT FÜR INTERNATIONALES PRIVATRECHT [RABELSZ] 470, 471 (2002) (pointing out that the Court can no longer cope with the rising number of proceedings it is facing); Jean-Paul Jacqué & Joseph H.H. Weiler, *On the Road to European Union—A New Judicial Architecture: An Agenda for the Intergovernmental Conference*, 27 COMMON MKT. L. REV. 185, 185-88 (1991) (describing the problem of the ECJ caseload); Mark C. Miller, *A Comparison of Two Evolving Courts: The Canadian Supreme Court and the European Court of Justice*, 5 U.C. DAVIS J. INT'L L. & POL'Y 27, 43 n.101 (1999); Peter F. Schlosser, *Lectures on Civil-Law Litigation Systems and American Cooperation with Those Systems*, 45 KAN. L. REV. 9, 27 (1996).

308. *See, e.g.*, FORTENTWICKLUNG DES RECHTSSCHUTZES IN DER EUROPÄISCHEN GEMEINSCHAFT 291 (Jürgen Schwarze ed. 1987).

309. *See, e.g.*, Hess, *supra* note 307, at 471 n.1.

310. Of course, even to the extent that corporate law is not harmonized, the national court may still refer those questions to the European court of Justice that involve European Community law. For example, a party may claim that a state's corporate law violates the Freedom of Establishment by restricting corporate mobility. However, in the absence of legal harmonization, there will be few cases where national corporate law is at risk of violating EC law. Moreover, the risk of such violations is not eliminated even if corporate law is harmonized, because directives and regulations can also violate the fundamental freedoms.

311. *See* ADMINISTRATIVE OFFICE OF THE COURTS, *supra* note 273, at 24.

312. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 903 (1990).

313. *See* THE COURT OF FIRST INSTANCE, THE ANNUAL REPORT 2002: STATISTICS OF JUDICIAL ACTIVITY OF THE COURT OF FIRST INSTANCE 182 (2002), http://curia.eu.int/en/instit/txtdocfr/index.htm.

314. *See id.*

315. *See* THE COURT OF JUSTICE OF THE EUROPEAN COMMUNITIES, THE ANNUAL REPORT 2002: STATISTICS OF JUDICIAL ACTIVITY OF THE COURT OF JUSTICE 161 (2002), http://curia.eu.int/en/instit/presentationfr/index.htm.

316. *See id.*

b. *The Courts of the Member States*

The institutional inadequacies of the ECJ leave the courts of the Member States to create a large and coherent body of precedents in the area of corporate law. In principle, the national courts remain able to generate precedents even after a certain area of the law has been harmonized. After all, courts are seldom required to request a preliminary ruling by the Court of Justice. Rather, they are only obliged to do so when a question of interpretation is raised in a case pending before a state court against whose decisions there is no judicial remedy under national law.[317] Additionally, and more importantly, the courts of the Member States typically don't even know about decisions rendered in other Member States. In part, that is because of existing language barriers—a German judge is unlikely to learn about a decision by a Spanish district court, even if that decision should happen to be published in the relevant Spanish law journals. Also, precedents from other Member States are not formally binding in the sense of *stare decisis*, so there is no reason for Member State courts to grant any deference to such decisions. Hence, even if these courts generate a large number of precedents, the relevant cases are unlikely to form a coherent system.

Last but not least, harmonization offers little hope of specialization on the part of state courts. To be sure, higher courts in the Member States of the European Community are often specialized. Consider, for example, the German Bundesgerichtshof, Germany's highest court in civil and criminal law matters. The Bundesgerichtshof has twelve chambers dealing with cases arising in the area of civil law, and one of these chambers is mainly responsible for corporate law litigation.[318] However, such specialization at the level of the highest courts is relatively useless once corporate law is harmonized. As mentioned before, Community law prevents the highest courts of the Member States from deciding the questions relating to the interpretation of Community law.

In sum, therefore, free choice offers far better prospects for the creation of a large and coherent body of case law than does a harmonized set of rules developed by the ECJ.

2. *The Market for Legal and Law-Related Services*

Another potential benefit of harmonization could lie in the creation of a Community-wide market for legal and law-related services. However, upon closer examination, it remains unclear whether harmonization—even assuming its political feasibility—would be significantly more successful at the creation of such a market than free choice.

It should be noted first that free choice will contribute in two ways to the creation of a Community-wide market for legal and law-related services. First,

317. *See* EC TREATY art. 234(3) ("Where any such question is raised in a case pending before a court or tribunal of a Member State against whose decisions there is no judicial remedy under national law, that court or tribunal shall bring the matter before the Court of Justice.")

318. *See* Der Bundesgerichsthof, *Geschäftsverteilungsplan des Bundesgerichtshofes für das Geschäftsjahr 2003*, http://www.bundesgerichtshof.de.

free choice will lead many corporations to be governed by identical law. As pointed out above, Europe can expect the emergence of a dominant jurisdiction.[319] Second, and just as importantly, free choice may well drive the states to adopt more uniform rules. Several factors deserve to be mentioned in this context. As has often been pointed out, uniformity is a natural consequence of the competition model.[320] Where states compete for corporate charters, they will often do so by copying successful innovations introduced by other states and may even try to copy the law of their more successful competitors wholesale.[321] Moreover, once a particular state law has established itself as the leading law regime, its very dominance may inspire imitation. Thus, as Klausner has pointed out, states may wish to copy the law of the most popular state of incorporation in order to give their citizens access to the network benefits associated with the dominant set of legal rules.[322] Furthermore, there is a general temptation for judges to follow courts from other jurisdictions. To do so not only diminishes the risk of adopting a solution that later proves impractical; it also helps the court to justify its decisions.[323]

The question remains, of course, whether harmonization will nevertheless be more effective than free choice at creating a Community-wide market for legal and law-related services. After all, one could argue that while under free choice, one corporate law regime predominates, and many other corporate law regimes will be similar to the prevailing regime, under harmonization all corporations are actually governed by the same law. This line of reasoning is ultimately unconvincing. Even setting aside the question of whether complete harmonization is politically feasible,[324] there are reasons why the uniformity to be achieved by harmonization has its limits. European

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319. *See supra* text accompanying notes 267-274.

320. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Hansmann & Kraakman, *supra* note 22, at 454 (pointing out that "cross-border competition for corporate charters can be a powerful force for convergence in corporate law"); Klausner, *supra* note 221, at 848-49; Romano, *Law as a Product*, *supra* note 5, at 229 & n.4 .

321. The latter has occurred in Nevada, which adopted Delaware law wholesale in an attempt to attract foreign corporations. *See* Cary, *supra* note 5, at 665.

322. Klausner, *supra* note 221, at 849.

323. *See* Jens C. Dammann, *The Role of Comparative Law in Statutory and Constitutional Interpretation*, 14 ST. THOMAS L. REV. 513, 551-54 (2002).

324. It should be quite clear to anyone acquainted with the history of corporate law harmonization in the European Community that complete harmonization is not currently feasible. It has taken the Member States of the European Community several decades to agree on the European Company, an organizational form that only complements, but does not replace national corporate law regimes. And even the European Company is not, strictly speaking, a purely federal corporation. *See supra* note 56. Those questions that are not answered by the pertaining regulation or other Community law are governed by the corporate law of the Member State where the corporation's statutory domicile and real seat are located. As the CR-SEC notes:

> An SE shall be governed . . . in the case of matters not regulated by this Regulation . . . by: (i) the provisions of laws adopted by Member States in implementation of Community measures relating specifically to SEs; (ii) the provisions of Member States' laws which would apply to a public limited-liability company formed in accordance with the law of the Member State in which the SE has its registered office; (iii) the provisions of its statutes, in the same way as for a public limited-liability company formed in accordance with the law of the Member State in which the SE has its registered office.

CR-SEC, *supra* note 56, art. 9(1)(c).

firms—traditionally governed by vastly different corporate law regimes—have long had different governance structures.[325] To impose a uniform corporate law regime on all of them would likely be inefficient, simply because such a move would impose considerable transition costs on many firms for whom the benefits of a uniform corporate law regime may be minimal. Indeed, harmonization has so far focused primarily on those matters that do not involve the organizational structure of the corporation.[326] As a result, adjustment costs are limited.[327] Should the European Community break with this tradition, however, and impose a uniform organizational structure on European corporations, the resulting costs would be considerable. Under free choice, this problem does not arise, because every firm can decide individually whether or not the benefits associated with the prevailing corporate law outweigh the disadvantages of having to change from one corporate law regime to another. However, harmonization proponents—in order to avoid inefficiencies relating to transition costs—would either have to settle for partial harmonization or would have to give European firms sufficient leeway to maintain their traditional structure. Either way, many of the advantages stemming from harmonization in terms of creating a Community-wide market for legal or law-related services would be lost. This is not to say, of course, that harmonization would not be somewhat better than free choice in creating such a market. However, for the reasons described above, the relative advantages of free choice in this area are likely to be limited.

D. *Political Externalities*

Despite the manifest advantages of free choice, one might attempt to defend harmonization on grounds unrelated to efficiency considerations. Harmonization, one might argue, produces positive externalities of a non-pecuniary nature by reinforcing the political coherence of a federal system. Assuming that political unity is a desirable goal,[328] legal harmonization is by no means an unusual means to this end. Throughout history, governments have used uniform law as a means of consolidating the nation.[329] Even today,

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325. *See supra* text accompanying notes 231-232.

326. *See generally* EDWARDS, *supra* note 298. Among the areas that have been wholly or partially harmonized are publicity requirements (first company law directive), *id.* at 19-20, legal capital requirements (second company law directive), *id.* at 60-61, mergers and divisions of companies (third and sixth company law directives), *id.* at 90-102, financial accounting and disclosure requirements (fourth, seventh, and eighth company law directives), *id.* at 117-211, and the law of single-member private limited companies (twelfth company law directive), *id.* at 219-27.

327. For example, legal capital requirements—one of the showpieces of legal harmonization in Europe—can be met regardless of whether a corporation has a one-tier or a two-tier board structure.

328. *See* TREATY ON EUROPEAN UNION, Feb. 7, 1992, pmbl., O.J. (C 191) 1 (1992), *amended by* TREATY OF NICE AMENDING THE TREATY ON EUROPEAN UNION, THE TREATIES ESTABLISHING THE EUROPEAN COMMUNITIES AND CERTAIN RELATED ACTS, Feb. 26, 2001, O.J. (C 80) 1 (2001) (according to which the parties to the treaty are "resolved to continue the process of creating an ever closer union among the peoples of Europe").

329. *See, e.g.*, Dan F. Henderson, *Law and Political Modernization in Japan*, *in* POLITICAL DEVELOPMENT IN MODERN JAPAN 389-91, 431-32 (Robert E. Ward ed., 1968) (pointing out that Japan, during the Meji era, adopted uniform codes as a means to unify the nation).

commentators in the Community frequently express the idea that uniform laws will promote the unification of Europe in a political and cultural sense.[330]

Nevertheless, it does not seem justified to list the above-described political externalities as a potential benefit of harmonization. To begin with, any political benefits to be derived from greater legal uniformity are extremely speculative. Legal uniformity may just as well turn out to be a liability to political unity by imposing a one-size-fits-all solution on a pluralistic body of citizens. The resulting discontent may increase rather than reduce the centripetal forces endangering political unity. More importantly, though, the free choice concept may well be a much more effective tool for preserving political unity than harmonization. The adoption of free choice will lead many corporations to reincorporate in other Member States. As a result, economic actors will invest heavily in the continued existence of free choice and—by extension—of the federal system. States will spend resources on improving their corporate law in the expectation that they will be able to reap monetary benefits by attracting foreign corporations.[331] Corporations will make the necessary expenditures to adopt the more efficient law of another state[332]—a move that may only be profitable in the long run,[333] when the costs of changing the corporation's legal structure will be outweighed by the benefits of operating under a more efficient corporate law. Corporate lawyers in all states will invest in free choice by acquiring legal expertise in the more popular corporate law regimes. To preserve the value of the various investments described above, the relevant actors have a strong interest in supporting the political unity of the federal system. Against this background, it does not seem justified to list the promotion of political unity as one of the potential benefits of harmonization vis-à-vis free choice. If positive political externalities are indeed relevant, free choice is at least as likely to maximize them as harmonization.

IV. CONCLUSION

The primary argument of this Article is that free choice is both a viable and desirable policy choice for the European Community.

At present, to be sure, corporate mobility still runs into a number of serious obstacles. Some of these obstacles are of a legal nature. They include the ability of the Member States to impose pseudo-foreign corporation statutes, the lack of provisions enabling corporations to undertake cross-border mergers without facing an extensive degree of legal uncertainty, and the Community rules on jurisdiction that expose corporations to litigation in

330. *See, e.g.*, Rodolfo Sacco, *Diversity and Uniformity in the Law*, 49 AM. J. COMP. L. 171, 172 (2001) (noting that "[u]niform law means cultural unity, and thus the elimination of misunderstandings and difficulties between different civilizations that must get on together").

331. *See* ROMANO, GENIUS, *supra* note 7, at 38-39 (describing Delaware's various transaction-specific assets in the chartering relation such as its reputation for responsiveness to corporate concerns, its body of case law, judicial expertise in corporation law, and administrative expertise in corporate filings).

332. *See id.* at 34-35 (pointing out various costs of reincorporation).

333. *See id.* at 36 (suggesting that the charter market is characterized by a non-simultaneity in performance).

the state of incorporation. Each of these obstacles, however, could be removed by enacting appropriate legislation at the Community level, thereby facilitating a large degree of corporate mobility.

There are also practical obstacles to the mobility of corporations in the European Community. These include conflicts of interest on the part of lawyers, the costs of changing one's lawyer, and the difficulties faced by pseudo-foreign corporations if they wish to litigate their internal affairs in the courts of the real seat state. It should be noted, however, that these obstacles can be expected to decline in importance as a dominant jurisdiction emerges in the Community market for corporate charters. Appropriate legislation at the Community level could also ensure that the obstacles to free choice faced by European corporations are scaled back considerably. Free choice, in short, is a viable policy option for the European Community.

The desirability of free choice is also readily apparent. In the context of the European Community, free choice is likely to generate more efficient results than harmonization. Indeed, the benefits to be derived from free choice may well be more substantial in the European Community than they are in the United States.

Most importantly, European corporations are likely to migrate toward those states that offer the most efficient corporate law. Moreover, the Member States—under pressure from local attorneys not to remain passive in the charter market—will probably engage in a race for quality, competing with each other more vigorously than their U.S. counterparts. Franchise fees, though currently prohibited by Community law, could also be expected to play a major role as an incentive to compete, provided that their current prohibition at the Community level is repealed. Many of the smaller Member States—especially among those countries that are set to join the European Community in 2004—have strong reasons to compete for corporate charters, as even a fraction of the revenues that Delaware derives from the U.S. charter market would be of enormous importance to these states. Finally, free choice would facilitate the emergence of a corporate law regime with a rich and coherent body of case law.

With regard to all of the above, it is important to note that free choice, in order to be a viable and desirable policy option for the European Community, does not have to operate in exactly the same way as it does in the United States. Indeed, in the European context, both the obstacles to free choice and the factors allowing that concept to function differ substantially from their U.S. counterparts. However, as this article has shown in much detail, despite and—in part—because of these differences, free choice can be expected to produce more efficient results than harmonization. In sum, therefore, the European Community would be well-advised to abandon its current trend towards harmonization and to embrace free choice as the basic tenet underlying corporate law.

APPENDIX: RECOMMENDED LEGISLATIVE CHANGES AT THE EC LEVEL

Mergers	EC legislation should be adopted to require the Member States to allow cross-border mergers.
Pseudo-Foreign Corporation Statutes	Depending on how liberally the ECJ applies the imperative requirements doctrine, it may be necessary to adopt EC legislation further limiting the extent to which the Member States can apply their local corporate law to pseudo-foreign corporations.
Jurisdiction	CR-JREJ Article 22(2)(1), which provides for the exclusive jurisdiction of the "seat state" over certain internal affairs of the corporation, should be eliminated. CR-JREJ Article 60(1)(a), which provides that the corporation is domiciled at the place where its statutory seat is located, should be eliminated.
Franchise Taxes	Article 2(1) of Council Directive 69/335/EEC should be amended to allow the state of incorporation to impose franchise taxes on all domestic corporations.
Advertisement by Lawyers	Community law should provide that advertisement by corporate lawyers is admissible as long as that advertisement is neither misleading nor deceptive.