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Publication Date
2005-10-01

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BEYOND COMPETITION FOR INCORPORATIONS

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October 2005

Forthcoming in the Georgetown Law Journal

This Article documents and analyzes a powerful form of regulatory competition — competition for investments — that has transformed national corporate laws in the European Union in recent years. Unlike the competition for incorporations that shapes Delaware corporate law and, by some accounts, the corporate laws of other American states as well, competition for investments sparks innovation in corporate law when firms cannot incorporate outside the jurisdiction in which they operate, and is designed to attract investments in local businesses rather than incorporations by foreign businesses. The high political payoffs that await successful participants in the competition for investments enable them to overcome opposition that could stifle competition for incorporations. And, together with the fact that no single jurisdiction in the European Union can dominate the market for investments, these payoffs drive multiple jurisdictions, including large ones, to compete. Allowing firms to incorporate outside the jurisdiction in which they operate, as a recent series of European Court of Justice rulings requires, may or may not breed competition for incorporations. Either way, however, as long as the competition for investments does not lose its steam, the effect on firms will be quite the same. Judging from the reforms that the competition for investments has fueled so far, the effect will be positive.

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INTRODUCTION

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

Nearly half a century of legal scholarship has produced scores of articles explaining state corporate laws in the United States as a

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

From here it is a small step to apply the same analysis to other parts of the world, with the European Union as a natural place to start.[3] Only the European Union does not meet a necessary condition for a market of incorporations to evolve. Unlike American states, most member states in the European Union follow the so-called real-seat rule, which prevents companies operating in these member states from

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[1] *Compare* Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679 (2002) (arguing that no American state but Delaware is actively pursuing incorporations), Lucian Bebchuk & Assaf Hamdani, Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition over Corporate Charter, 112 Yale L.J. 553 (2002) (same), Ronald Gilson, Presentation at the American Law Institute and the European Corporate Governance Institute Conference on Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective, http://www.ecgi.org/tcgd/launch/gilson_speech.php (Jul. 12, 2004) (same), Melvin Eisenberg, Presentation at the American Law Institute and the European Corporate Governance Institute Conference on Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective, http://www.ecgi.org/tcgd/launch/eisenberg_speech.php (Jul. 12, 2004) (same), *and* Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003) (arguing that Delaware's real competition is the federal regulator), *with* Roberta Romano, Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?, 21 Oxford Rev. Econ. Pol. 221 (2005) (arguing that all American states pursue incorporations).

[2] *Compare* Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225 (1985) (arguing that competition produces efficient law), Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913 (1982) (same), Ralph K. Winter, Jr., Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977) (same), *with* William L. Cary, Federalism and the Corporation: Reflections upon Delaware, 83 Yale L.J. 663 (1974), *and* Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State competition in Corporate Law, 105 Harv. L. Rev. 1435 (1992).

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

incorporating abroad.[4] If this rule were to change, commentators have argued, intense competition for incorporations would immediately follow.[5]

This moment of truth has arrived. In fact, it arrived several years ago, when the first in a series of decisions by the European Court of Justice required member states to recognize companies incorporated in other member states and to refrain from imposing local corporate law on them.[6] Will the new freedom to choose where to incorporate unleash a fierce race among member states to win incorporations? Probably not. There is no reason to believe that European countries

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[4] *See* Eddy Wymeersch, The Transfer of the Company's Seat in European Company Law, 40 Common Mkt. L. Rev. 661, 666-73 (2003) (reviewing legal barriers to incorporation abroad).

[5] *See* Brian Cheffins, Company Law: Theory, Structure and Operation 443 (1997) (arguing that legal professionals may drive the United Kingdom to compete for incorporations); Simon Deakin, Regulatory Competition versus Harmonization in European Company Law, *in* Regulatory Competition in European Company Law: Comparative Perspectives 190, 204-05 (Daniel C. Esty & Damien Geradin eds., 2001) (arguing that lawyers and accountants may drive member states to compete for incorporations); Gerard Hertig & Joseph A. McCahery, Corporate and Takeover Law Reforms in Europe: Misguided Harmonization or Regulatory Competition?, 4 Eur. Bus. Org. L. Rev. 179, 187 (2003) (arguing that small member states may compete for incorporations to obtain chartering revenue); Luca Enriques, EC Company Law and the Fears of a European Delaware, 15 Eur. Bus. L. Rev. 1259, 1273 (2004) (arguing that a freedom to choose where to incorporate may pressure national legislators in European Union to emulate other jurisdictions' rules in order to retain existing incorporations, though not in order to attract incorporations from abroad); Eddy Wymeersch, Company Law in the Twenty-First Century, 1 Int'l & Comp. Corp. L.J. 331, 339 (1999) (arguing that a freedom to choose where to incorporate is certain to stimulate competition between member states); but see Matthias Baudisch, From Status to Contract? An American Perspective on Recent Developments in European Corporate Law, *in* The European Union and Governance 23, 54 (Francis Snyder ed., 2003) (arguing that sufficient incentives to compete for incorporations exist in the United States but not in the European Union).

[6] *See* Case 212/97, Centros Ltd v. Erhvervs-og Selskabsstyrelsen, [1999] E.C.R. I-1459 (requiring the Danish authorities to recognize a British company operating in Denmark); Case 208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC), [2002] E.C.R. I-9919 (requiring the German authorities to recognize a Dutch company operating in Germany); Case 167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd, [2003] E.C.R. I-(30.9.2003) (requiring the Dutch authorities to recognize a British company operating in the Netherlands). While these three decisions are most commonly cited in describing the trend, earlier decisions making similar holdings exist. *See, e.g.*, Case 79/85, D.H.M. Segers v. Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen, [1986] E.C.R. 2375 (requiring the Dutch authorities to recognize a British company operating in the Netherlands).

will be any more interested in incorporations than most American states, which make virtually no visible efforts to compete with Delaware.[7] The European Union may indeed remain without a single member state motivated to compete like Delaware because the member state that corporate decisionmakers favor for incorporation — the United Kingdom — does not compete for incorporations and is unlikely to begin doing so in the future.

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

This renaissance of corporate legislation within the European Union is not merely extraneous to any market for incorporations. It actually *draws* on the fact that no such market exists. If companies could easily incorporate abroad, companies operating in member states with inferior corporate laws would be less disadvantaged in the quest for investments, and their home member states would see less urgency in reforming their corporate laws than today. But without the ability to incorporate abroad, these companies are hamstrung by the corporate laws where they are based. Ironically, precisely because firms *cannot* incorporate elsewhere, member state legislatures have needed to ensure that local corporate law meets the expectations of the international investor community. This is certainly competition, and an intense one at that, but it owes its very existence to the fact that a market for incorporations does not exist.

Competition for investments is different from competition for incorporations not only in its origin but also in its potency. The incentives for lawmakers to pass laws that would stimulate economic growth and address public concerns about corporate mismanagement are much stronger than the incentives to pass laws meant to attract incorporations by foreign firms. Competition for investments can therefore overcome political and economic obstacles that competition for incor-

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[7] *See supra* note 1.

poration cannot. In the European Union, competition for investments has overcome opposition from labor and management lobbies, and has resulted not only in the copying of foreign law but also in the formation of regulatory agencies with real powers and considerable costs of operation. In terms of political and financial commitment, this is more than any American state has done in a century.

The policy implications of this analysis depart significantly from the conventional wisdom about the likely outcome of giving companies the freedom to choose where to incorporate. Allowing firms to incorporate abroad may not only fail to foster new competition, but indeed may *weaken* the competition that already exists. To be sure, the outcome will be different if enough local companies remain incorporated in their home member states. The lack of regulatory interest in companies that incorporate abroad would then be offset by the drive to continue developing the law to the benefit of local companies. This drive may persist especially if the reforms of the last fifteen years have sufficiently transformed national economies and politics to create a momentum that can perpetuate itself. But all this will not be a result of competition for incorporations. It will still be competition for investments.[8]

This analysis contributes to the growing literature on convergence of corporate governance and path dependence. One strand in the literature, associated with Lucian Bebchuk and Mark Roe, focuses on limits to the power of globalization to pull corporate laws around the world towards greater efficiency.[9] The other strand, associated with Henry Hansmann and Reinier Kraakman, holds that these limits, while real, will over time yield to the forces pushing for change.[10] This Article complements the discussion by documenting the forces of convergence at play and relating them to the debate on regulatory

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[8] This outcome is not guaranteed. If too many companies incorporate abroad, or if the momentum created by previous reforms is not stable, corporate laws in member states whose firms exit in droves will atrophy. The result may well be a correlation between the retention of local incorporations on the one hand, and the quality of corporate law on the other hand. But it will reflect a softening of the competition for investments, rather than the emergence of competition for incorporations.

[9] *See* Lucian Bebchuk & Mark Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999); *see also* William W. Bratton & Joseph A. McCahery, Comparative Corporate Governance and the Theory of the Firm, 38 Colum. J. Transnat'l L. 213 (1999).

[10] *See* Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L.J. 439 (2001); *see also* Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 49 Am. J. Comp. L. 329 (2001).

competition.[11] In particular, it recasts legal convergence as a form of regulatory competition that is not only more powerful than competition for incorporations, but indeed dependent on the very absence of a necessary condition for competition for incorporations to exist.[12] Moreover, this analysis argues that, in a departure from the predictions of the convergence literature, recent history shows that competition for investments may push lawmakers to lead the way to convergence more rapidly than firms. The reason for this is twofold. First, lawmakers can transform the legal system as a whole and thus overcome complementarities that have developed between its parts. Second, in a twist of logic, lawmakers can create value by ignoring the transition costs that reform imposes on existing firms and focus instead on their own political capital, which is tied to the success of new firms that result from privatizations.

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[11] Previous commentators have anecdotally mentioned changes in corporate laws in the European Union driven by competition for investments as part of their analysis of competition for incorporations. *See* Joseph A. McCahery & Erik P.M. Vermuelen, Limited Partnership Reform in the United Kingdom: A Competitive, Venture Capital Oriented Business Form, 5 Eur. Bus. Org. L. Rev. 61, 75 (2004); William W. Bratton & Joseph A. McCahery, The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World, 86 Geo. L.J. 256, 256-59 (1997) (yardstick competition). This Article reverses the focus. It argues that competition for investments far exceeds in importance the competition for incorporations as an explanation of corporate lawmaking in the European Union, and analyzes the fundamental differences between the two types of competition.

[12] Competition for investments is different from yardstick competition (or benchmark competition) by involving efforts by regulators to attract and retain a share of a limited pool of mobile capital. Yardstick competition — efforts by suppliers serving different consumer markets to match each other's performance — was originally suggested as a way of ensuring that regulated monopolies do not overcharge customers. *See* Andrei Shleifer, A Theory of Yardstick Competition, 16 Rand J. Econ. 319 (1985). Subsequently, yardstick competition was said to be the method voters use to evaluate local lawmakers. *See* Pierre Salmon, Decentralisation as an Incentive Scheme, 3 Oxford Rev. Econ. Pol. 24 (1987). Corporate lawmaking in the European Union can also be shaped by yardstick competition, whereby national governments satisfy voters by matching foreign corporate laws. *See* Pierre Salmon, Political Yardstick Competition and Corporate Governance in the European Union (European Corporate Governance Institute Law Working Paper No. 38/2005, May 2005), http://ssrn.com/abstract=730385. For the distinction between yardstick competition and mobility-based competition generally, see Pierre Salmon, Horizontal Competition among Governments, *in* Handbook of Fiscal Decentralization (Ehtisham Ahmad & Giorgio Brosio eds., forthcoming 2005).

I. COMPETITION FOR INVESTMENTS

Until recently, firms in most member states of the European Union were unable to incorporate abroad. Competition for incorporations was therefore impossible. But this lack of legal domicile mobility did not prevent the emergence of another type of regulatory competition. This competition is hardly hidden. It is very visible and seems to motivate member states to do everything they would do if they competed for incorporations. They reform their laws. They imitate each other. They protect shareholders. Only they are not competing for incorporations. They are competing for investments.

The pursuit of investments involves the creation of a hospitable business environment. This is partly achieved through financial incentives, such as tax breaks, subsidies, loans, monopoly rights, and other direct transfers. It also means offering the necessary physical and legal infrastructure on which businesses rely for their development. For many years, corporate taxation was the main dimension on which states competed for investments. But the globalization of capital, products, and labor markets generally, and the economic integration of the European Union particularly, intensified the competition for investments among its member states and rendered tax competition insufficient. In addition, the need to shore up budget deficits pushed some member states to mass privatization, which in turn increased the extent of public stock ownership and the dependence on equity markets. All these changes, together with a prolonged economic stagnation, the collapse of major domestic corporations, and a growing awareness of the link between law and finance, led lawmakers to begin leveraging corporate law reform as an additional way to attract investments. As a result, the European Union saw waves of reforms aimed at modernizing corporate law and increasing shareholder protection.

A. The Old Way: Tax Incentives

A time-honored method of stimulating the economy is offering tax incentives.[13] In the European Union, the member states most often

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[13] Tax incentives designed to stimulate economic activity, which are considered a legitimate form of competition, are distinguishable from tax incentives designed to capitalize on economic activity conducted in another country in return for sheltering this activity from being taxed at a higher rate by that other country. According to corporate practitioners, the latter type of tax incentives "may look attractive, but if the real management is to remain in another place, that territory is likely to assert taxing jurisdiction." *See*

mentioned in this regard are Ireland and the Netherlands.[14] Ireland is well known for charging a low corporate tax on revenue earned within its borders.[15] It aggressively pursues foreign businesses by claiming to have "one of the most beneficial corporate tax environments in the world," and the lowest corporate tax rate in the European Union. The motivation behind this taxation system is no secret. As recently explained by Ireland's then-finance minister in rejecting a call from France and Germany to establish a minimum corporate tax rate:

> Ireland had successfully and determinedly pursued a policy of low personal and business taxation, including our 12.5 per cent rate of Corporation Tax, with spectacular success. We have created a dynamic employment and investment-friendly environment in which over 300,000 new jobs have been created and countless tens of thousands of existing jobs maintained over the past 7 years.[16]

The Netherlands is known for its favorable taxation of holding companies' revenues.[17] Corporate law practitioners are well aware of

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Public Takeovers in Europe, Freshfields Bruckhaus Deringer Memorandum to Clients, at 32 (Summer 2004), http://www.freshfields.com/practice/corporate/publications/pdfs/public takeovers/Europe2004.pdf.

[14] *See* William W. Bratton & Joseph A. McCahery, Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation, 38 Common Mkt. L. Rev. 677, 701 (2001) (noting that Ireland and the Netherlands are known for their hospitable tax regime); Gimme Shelter: Is Tax Competition among Countries a Good or a Bad Thing?, Economist, Jan. 29, 2000 (reporting widespread tax competition around the world and naming Ireland, the Netherlands, and Luxembourg as the member states of the European Union engaged in tax competition).

[15] *See, e.g.*, e-mail from Jiampiero Miccoli, Associate, Janni, Magnocavallo, Fauda, Brescia e associati, Milan, to Ehud Kamar, Aug. 19, 2004 (noting that certain Italian pharmaceutical companies have their production plants in Ireland because taxation on production there is low); Christine Kelly, Finance Bill 2004 — Holding Company Provisions, http://www.idaireland.com/uploads/documents/Finance_Taxation/Finance_Bill_2004.doc (explaining that a recent bill to improve the tax treatment of Irish holding companies was designed to encourage holding companies to expand their activities in the areas of financial control, research and development, and intellectual property so as to become a hub for European activities of their respective groups).

[16] Press Release, McCreevy Rejects Corporation Tax Harmonisation Proposals (Ireland Department of Finance, Jun. 8, 2004), http://www.finance.gov.ie/Viewtxt.asp?DocID=2187&CatID=1&m=n&StartDate=01+January+2004.

[17] *See* Andrew Ross Sorkin, Is the Dutch Advantage Unsettling Europe?, N.Y. Times, April 2, 2000, at Money and Business 4. Recently, Ireland started to compete with the Netherlands in this market. *See* Abigail St. John Kennedy, Ireland, *in* The International Financial Law Review Guide to Mergers and Acquisitions 2004, http://www. legalmedia-group.com/IFLR/includes/print.asp?SID=5248 (Ireland) (reporting a government proposal from 2004 to exempt from tax gains from disposition of substantial shareholding in subsidiaries located in the European Union or in countries with which Ireland has a taxation treaty, and offer improved double tax credits on foreign dividends).

these advantages.[18] Here, too, the goal is economic stimulation.[19] Accordingly, as a condition for enjoying the tax breaks, holding companies must establish a physical presence in the Netherlands.[20] Ireland and the Netherlands are not the only member states that use such tax incentives to attract business. Other member states do the same.[21]

But offering tax incentives is very different from using corporate law to attract incorporations.[22] Delaware, the paragon of competition for incorporations, relies on its corporate legal regime, rather than on tax breaks, to attract incorporations Its goal is to have companies

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[18] *See* Miccoli, *supra* note 15 (noting that most major Italian companies have their holding company in the Netherlands because so far taxation on dividends there has been lower than in Italy); Interview with Christopher Norall, Partner, and Rony P. Gerrits, Associate, Morrison & Foerester, Brussels, Jun. 22, 2004 [hereinafter Norall & Gerrits Interview] (noting that many holding companies operate from the Netherlands because of its tax benefits); Telephone Interview with Scott V. Simpson, Partner, Skadden, Arps, Slate, Meagher & Flom, London, Jul. 27, 2004 (noting that tax advantages stemming from international treaties have attracted to the Netherlands holding companies such as Italian fashion house Gucci Group and American real estate company Rodamco North America). Scott Simpson has represented Gucci Group since 1997 and represented Westfield Group (Australia) in its 2002 acquisition of Rodamco North America. *See* http://www.skadden.com/index.cfm?contentID=45&bioID=1261.

[19] *See* e-mail from Ernst Barten, Stibbe, Amsterdam to Ehud Kamar, Sept. 22, 2004 (noting that the purpose of offering tax incentives to Dutch holding companies is to make the Netherlands attractive as a business location).

[20] *See id.* (noting that a Dutch holding company must be managed and controlled in the Netherlands to be exempt from tax in the Netherlands on gains arising from holding or selling shares of a qualifying subsidiary and to be able claim a tax deduction for interest paid to purchase these shares); Ernst & Young, Ireland 12.5% Corporate Tax and Other Tax Advantages (Nov. 2002), http://www.ey.com/global/download.nsf/Ireland/tax_12.5_percent_corporate_tax/$file/12.5percent%20brochure.pdf (noting that companies, regardless of their place of incorporation, are Irish tax-resident if they are managed and controlled in Ireland).

[21] For discussion by corporate lawyers of tax advantages their member states offer to companies, see Menelaos Kyprianou, Cyprus as a Venue for the Establishment of a Holding Company, Int'l Bus. Law., Apr. 2004, at 66 (Cyprus); Bente Møll Pedersen & Michael Hertz, Legal Aspects of Acquiring a Publicly Traded Danish Company, Int'l Bus. Law., Sept. 2000, at 365, 368 (Denmark); Erik Björkeson & Peter Sjögren, The New Holding Company Regime in Sweden, Delphi & Co. Memorandum to Clients (Feb. 2004), http://www.delphilaw.com/data/content/DOCUMENTS/200435162258718The%20new%20Holding%20Company%20Regime%20in%20Sweden.pdf (Sweden).

[22] Indeed, even municipalities, which are unable to offer incorporations, dole out substantial tax incentives to attract business. *See, e.g.*, Gary Washburn, Boeing Got a Lot, but It Isn't Alone, Chi. Trib., May 13, 2001, at 1 (noting that Chicago has been using tax concessions quite liberally to attract business to the city).

choose Delaware as their legal domicile, rather than as their physical home. In fact, the so-called franchise tax Delaware charges to companies incorporated in the state (which is different from the tax it charges to companies on revenue they earned within the state regardless of where they are incorporated) is higher than the franchise tax other American states charge, not the other way around.[23] By contrast, Ireland and the Netherlands strive to build their manufacturing and services sectors, rather than the list of foreign businesses using their laws. Accordingly, those countries rely on tax incentives, rather than their corporate legal regimes, to achieve this goal.[24] To be sure, incorporation in these member states can help to establish tax residency in them and the ability to enjoy their tax benefits. But the ultimate test for tax residency in these member states — as it is anywhere in the European Union — is management and control rather than incorporation, and the motivation for incorporating in these member states is saving taxes rather than benefiting from their corporate laws.[25]

B. The New Way: Corporate Law

Tax breaks are not the only way to stimulate the economy. Many other inducements can be offered to encourage growth under the label of business-friendly legislation. The globalization of capital markets, together with the economic integration of the European Union, has made corporate law reforms an important component of the pro-business legislation that lawmakers in the various members states are expected to provide. The reason, ironically, is that firms currently *do not* have the freedom to incorporate abroad. They are trapped within their home member states. If member states are to attract investments in local companies, they must therefore see to it that the legal protection they afford to investors does not fall behind.

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[23] *See* Kahan & Kamar, *supra* note 1, at 690 t.1 (comparing annual taxes for incorporation in the fifty states and the District of Columbia).

[24] *See* http://www.idaireland.com (website of the Ireland Development Authority, which bills itself as an "Irish Government agency with responsibility for securing new investment from overseas in manufacturing and internationally traded services sectors" and advertises Ireland's "skilled and flexible workforce," "[o]ne of the lowest corporate tax rates in the world," "[y]oungest and one of the best educated populations in Europe," and a "positive political and economic environment" — without mentioning Ireland's corporate law).

[25] *See* Telephone Interview with Jan Karel Weststrate and Steven Claes, International Tax Services, Ernst & Young, New York (Jun. 16, 2005).

This pressure did not exist several decades ago, when capital markets were segmented and investments were local. But the globalization of capital markets and the economic integration of the European Union in recent years have created a new reality in which member states cannot take investors for granted, and cannot afford to lose investments — including those by their own citizens — by continuing to keep unattractive corporate laws that apply to any company conducting business within their borders.[26] Between 1987 and 1996, for example, American investors nearly tripled the portion of foreign investments in their stock portfolios, from 3.8 percent to 10 percent, adding an important consideration to the political calculus of lawmakers in the European Union.[27] Between 1995 and 1999, the share of foreign investments by European investment funds increased from approximately 40 percent to nearly 70 percent.[28] Their investments too could no longer be taken for granted.[29]

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[26] The pressure on jurisdictions to provide hostage local companies with the necessary legal environment for growth is analogous to the pressure that illiquid institutional investors exert on companies to raise their corporate governance standards. *See* John C. Coffee, Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991) (arguing that the size of institutional investments in public companies, the need to diversify investments, and the demand for investment portfolios that track stock indexes all limit liquidity and force intuitional investors to monitor managers more than they would otherwise); Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445 (1991) (same). Both are pressures to change debilitating rules when those governed by them cannot escape their application — a tradeoff referred to by economists and political scientists as a resort by the regulated population to voicing its discontent with the rules in the absence of an exit option. *See* Albert O. Hirschman, Exit Voice and Loyalty: Responses to Decline in Firms, Organizations, and States (1970).

[27] *See* Linda Tesar & Ingrid Werner, The Internationalization of Securities Markets Since the 1987 Crash, *in* Brookings-Wharton Papers on Financial Services 281 (1998).

[28] *See* Lieven Baele et al., Measuring European Financial Integration, 20 Oxford Rev. Econ. Pol. 509, 528-29 (2004). The share of foreign investments by these funds within Europe increased over that period from about 18% to about 30%. *See id.* The integration of European equity markets is also manifested in a tripling of the part of the variance of European stock returns explained by news common to all Europe from about 8% in 1973-86 to about 23% in 1999-2003. The part of the variance of European stock returns explained by American news doubled over that period from about 11% to about 20%, suggesting that European equity markets integration proceeded faster than global equity markets integration. *See id.* at 526-27; *see also* Geert Bekaert, Campbell R. Harvey & Angela Ng, Market Integration and Contagion, 78 J. Bus. 39 (2005) (reporting evidence of global integration of equity markets).

[29] *See* Federation of European Stock Exchanges, European Share Ownership Structure 2002, at 3, http://www.fese.org/statistics/share_ownership/share_ownership. pdf

This transformation intensified competition for investments in a number of ways. First, it pressured firms to grow while depleting their internal cash reserves and forcing them to raise new capital or use their stock as acquisition currency.[30] Second, it motivated firms to move production abroad to lower costs, including costs associated with operating under the law of their home member state. Third, it shrank the profits into which managers could dip to extract private benefits, weakening their resistance to change.[31] Fourth, it prompted massive privatizations, which depended on the quality of local corporate law.[32]

The agents of legal change varied across member states according to their institutional and political settings. In some member states, interest groups that would benefit from the change openly demanded it. Such was the case in Germany, where a new breed of investment banks emerged that tied their survival to the existence of a vibrant stock market and lobbied for reform.[33] In other member states,

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[hereinafter Share Ownership Survey] (reporting that globalization and the introduction of the euro have resulted in the emergence of foreign institutional investors as the driving force of European markets and in the increase of foreign holdings by domestic institutional investors).

[30] A well-known example is the acquisition of United States carmaker Chrysler by German carmaker Daimler Benz in 1998, which required the acquiring company to register its stock in the United States and subject itself to United States accounting principles prior to the acquisition.

[31] *See* Mark J. Roe, Rents and their Corporate Consequences, 53 Stan. L. Rev. 1463 (2001) (arguing that the availability of monopoly rents helps to explains the persistence of weak shareholder protection in European corporate law); Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparison, 59 J. Fin. 537 (2004) (arguing that product market competition lowers monopoly rents and leaves less room for extracting private benefits of control).

[32] The active interest that governments in countries undergoing extensive privatization take in corporate law is illustrated by the frustration in the Italian government with the 1997 ouster of the chairman of recently privatized Telecom Italia by directors averse to reform. *See* Paul Betts & James Blitz, At the Head of Italy's Table, Fin. Times, Dec. 22, 1997, at 14 (quoting the Italian prime minister saying: "We are carrying out privatisations but we still have not done enough to create a proper financial market. . . We do not have guarantees for small shareholders, no rules for public companies.").

[33] *See* Richard Deeg, Finance Capitalism Unveiled: Banks and the German Political Economy 90-93 (1999) (describing the transition of major German banks from lending to investment banking, the penetration of the German banking industry by foreign investment banks, and the lobbying by both groups of banks for corporate reform). Perhaps no German bank has changed more than Deutsche Bank, which has filled its top posts with U.S.-trained investment bankers and reduced corporate lending. *See* Janet Guyon, The Trials of Josef Ackermann, Fortune, Jan. 26, 2004, at 111. Recently, the chairman of its supervisory board of directors joined the growing criticism of employee representation on supervisory boards. *See Deutsche Bank Sichtet Fusionskandidaten* [Deutsche Bank Looks for Merger Candidates], Frankfurter Allgemeine Zeitung, Jun. 5, 2004, at 11.

government officials acted as political entrepreneurs by personally pushing for change.[34] This was the case in Italy, where corporate reform was been advanced by individuals such as prime ministers Giuliano Amato (who at other times served as treasury minister and head of the antitrust authority) and Romano Prodi (who later headed the state corporate holding apparatus that led the privatization process); treasury director, commissioner of privatization, and drafter of the new corporate law, Mario Draghi (who received his doctorate in economics in the United States); and Bank of Italy governors Carlo Azeglio Ciampi (who later became treasury and economics minister, and president) and Antonio Fazio.[35] Thus, for example, in a 1998 article titled "Corporate Governance and Competitiveness," Mario Draghi described his vision of corporate law and financial regulation as drivers of national economic growth through "increasingly competitive market rules and standards of company law" where "the ability of national enterprises to raise funds will depend to an ever greater extent on the efficiency of Italy's 'financial centre' and the 'quality' of the products, representing administrative as well as property rights, that are traded."[36] And in all member states, pressure was applied by institutional investors, who relied on their growing equity holdings to voice their concerns to corporate managers and lawmakers alike.[37]

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[34] *See* Russel Hardin, Collective Action 35-37 (1982) (describing political entrepreneurs as public figures who advance their own careers by promoting a certain public or group interest).

[35] *See* Richard Deeg, Remaking Italian Capitalism? The Politics of Corporate Governance Reform, 28 W. Eur. Pol. 521, 529 (2005).

[36] *See* Mario Draghi, Corporate Governance and Competitiveness, Rev. Econ. Conditions in Italy, Sept.-Dec. 1998, at 341, 345. Prior to becoming director general of the Italian treasury, Draghi served as advisor to the Bank of Italy and executive director of The World Bank. Draghi also served over the years as board member of Banca Nazionale del Lavoro, Gruppo Sanpaolo IMI, Eni, and Information Resources. In 2002, he joined Goldman Sachs International as managing director and vice chairman. *See* Press Release, Professor Mario Draghi Joins Goldman Sachs (Jan. 28, 2002), http://www.gs.com/our_firm/media_center/articles/press_release_2002_article_918590.html.

[37] American pension fund CalPERS (California Public Employees' Retirement System) had at the end of July 2004 assets worth $163.5 billion, $34.2 billion of which were shares of companies outside the United States. It dedicates a section of its website to its corporate governance philosophy in general and international investments in particular, with tailored corporate governance principles for investment in the United Kingdom, Germany, and France. *See* International Corporate Governance, http://www.calpers-governance.org/principles/international. Similarly, British fund manager Hermes managed at the end of June 2004 assets worth $82 billion, $23 billion of which were shares of companies outside the United Kingdom. Like CalPERS, it dedicates a section of its website

The competition for investments has had a very noticeable impact on member state legislation.[38] Consider the following anecdotes.

Germany began its journey to shareholder capitalism in the second half of the 1980s as part of a campaign to make the country a desirable place for production (*Wirtschaftsstandort Deutschland*),[39] which later mutated into a campaign to strengthen the country's position as a finance center (*Finanzplatz Deutschland*).[40] Early reforms were designed to modernize the existing platforms for securities trading. They included the introduction of electronic trading on the national stock exchange in 1986,[41] amendments to the stock exchange law in 1989,[42] the elimination of taxes on stock trading in 1989;[43] and the opening of a futures exchange in 1990.[44]

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to corporate governance both domestically and internationally, with translations to French and Italian. *See* http://www.hermes.co.uk/publications/publications_corporate_governance.htm. Institutional investors even travel abroad to clarify their expectations. *See, e.g.,* James A. Fanto, The Transformation of French Corporate Governance and United States Institutional Investors, 21 Brook. J. Int'l L. 1, 70 (1995) (noting that the general counsel of CalPERS and the head of Global Proxy Services traveled to France before the privatizations began to discuss corporate governance with government officials). Most importantly, institutional investors vote with their feet against countries with inadequate law. *See* Kalok Chan, Vicentiu Covrig & Lilian Ng, What Determines the Domestic Bias and Foreign Bias? Evidence from Mutual Fund Equity Allocations Worldwide, 60 J. Fin. 1495 (2005); Christian Leuz, Karl V. Lins & Francis E. Warnock, Do Foreigners Invest Less in Poorly Governed Firms? (Working Paper, Feb. 2005), http://ssrn.com/abstract=512042; Mariassunta Giannetti & Yrjö Koskinen, Investor Protection and the Demand for Equity (European Corporate Governance Institute Finance Working Paper No. 64/2004, Dec. 2004), http://ssrn.com/abstract=554522.

[38] *See, e.g.*, Matthew Valencia, Good Heavens, Good Governance, Economist, Apr. 29, 2000 (quoting the editor of a corporate governance newsletter referring to an "enormous uptick" in both legislation and practice in continental Europe).

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

[40] *See* Jürgen Beyer & Martin Höpner, The Disintegration of Organised Capitalism: German Corporate Governance in the 1990s, 26 W. Eur. Pol. 179, 191 (2003).

[41] *See* Richard Deeg, Change from Within: German and Italian Finance in the 1990s, *in* Beyond Continuity: Institutional Change in Advanced Political Economies 169, 180 (Wolfgang Streeck & Kathleen Thelen eds., forthcoming 2005).

[42] See id.

[43] *See Gesetz zur Stärkung des Finanzplatzes Deutschland* [Law for the Stabilization of Finance Center Germany], also known as *Erstes Finanzmarktförderungsgesetz* [First Financial Market Promotion Act] of Jul. 11, 1989, BGBl. I (1989), 1412; Eric Nowak, Investor Protection and Capital Market Regulation in Germany, *in* The German Financial System 425, 429 (Jan Pieter Krahnen & Reinhard H. Schmidt eds., 2004).

[44] *See* Deeg, *supra* note 41, at 180.

What followed were numerous laws to liberalize securities trading while tightening investor protection. They included a 1990 law requiring corporate issuers to prepare an offering prospectus;[45] a 1994 law banning insider trading, introducing disclosure obligations, and establishing a new securities agency charged with regulation and enforcement;[46] a 1998 law allowing companies to use American or international accounting standards;[47] a 1998 law deregulating investment funds;[48] a 1998 law broadening disclosure obligations, authorizing stock option compensation, expanding the responsibilities of supervisory boards, limiting voting by banks, requiring shares to have equal voting rights, and strengthening auditor independence;[49] a 2000 law using a capital gains tax exemption to encourage banks to liquidate their stock holdings;[50] a 2001 law regulating takeovers;[51] a 2002 law

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[45] *See id.*; *Gesetz über Wertpapier-Verkaufsprospekte und zur Änderung von Vorschriften über Wertpapiere* [Law on Prospectuses for Security Sales and on Revising Securities Regulation] of Dec. 13, 1999, BGBl. I (1990), 2749.

[46] *See Zweites Finanzmarktförderungsgesetz* [Second Financial Market Promotion Act] of Jul. 26, 1994, BGBl. I (1994), 1749; Nowak, *supra* note 43, at 429-33. The agency began to operate in 1995 with 96 staff members and a budget of DM 14.9 million. *See* Nowak, *id.* at 430; BAWe Annual Report 1996, at 6, www.bafin.de. *BAWe* stands for *Bundesaufsichtamt für den Wertpapierhandel* [Federal Securities Supervisory Office]. By the end of 2000, the agency had a staff of 138 and a budget of DM 18.07 million. *See* BAWe Annual Report 2000, at 39-40, www.bafin.com. In 2002, the agency was combined with the banking and insurance agencies to form a single financial services agency, the Federal Financial Supervisory Authority (*Bundesantalt für Finanzdiensleistungsaufsicht,* or *BaFin*). *See Gesetz über die integriete Finanzaufsicht* (*FinDAG*) [Law on Integrated Financial Services Supervision] of Apr. 24, 2002, BGBl. I (2002), 1310.

[47] See Gesetz zur Verbesserung der Wettbewerbsfähigkeit deutscher Konzerne an Kapitalmärkten und zur Erleichterung der Aufnahme von Gesellschafterdarlehen [Law for Improving the Competitiveness of German Companies in Capital Markets and Facilitating the Taking of Loans by Shareholders], also known as Kapitalaufnahmeerleichterungsgesetz (KapAEG) [Capital Raising Relief Act] of Apr. 20, 1998, BGBl. I (1998), 707; Nowak, supra note 43, at 435. For the positive response to the law in business circles, see Martin Glaum, Bridging the GAAP: the Changing Attitude of German Managers towards Anglo-American Accounting and Accounting Harmonization, 11 J. Int'l Fin. Mgm't & Acct. 1 (2000).

[48] *See Drittes Finanzmarktförderungsgesetz* [Third Financial Market Promotion Act] of Mar. 29, 1998, BGBl. I (1998), 529; Nowak, *supra* note 43, at 434-35.

[49] *See Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (*KonTraG*), Apr. 27, 1998, BGBl I (1998); Nowak, *supra* note 43, at 435-37

[50] *See Steuererleichterungsgesetz* [Tax Reduction Act] of Jul. 2000; Nowak, *supra* note 43, at 437-38.

[51] *See Wertpapiererwebs-und Übernahmegesetz* (*WpÜG*) [Takeover Act] of Dec. 20, 2001, BGBI I (2001), 3822. Responding to management concerns raised by a recent takeover of German telephone company Mannesmann by British rival Vodafone, the law authorized supervisory boards to resist takeovers without shareholder permission. *See*

criminalizing market manipulation, requiring disclosure of director trading, and creating a private right of action for securities fraud;[52] a 2002 law requiring public companies to follow a code of corporate governance or disclose their failure to do so;[53] and a 2004 law modifying various areas of securities law.[54] The list of reforms continues to grow today. Current government proposals include, for example, a 2005 bill on shareholder class actions;[55] and a 2005 bill on shareholder derivative lawsuits.[56]

The British and American influence on these reforms is evident. Yet their goal was to boost economic growth, not to attract incorporations.[57] Apart from aiming to make Germany a finance center, the

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Jeffrey N. Gordon, An American Perspective on Anti-Takeover Laws in the EU: The German Example, *in* Reforming Company and Takeover Law in Europe 541 (Guido Ferrarini, Klaus J. Hopt, Jaap Winter & Eddy Wymeersch eds., 2004) (criticizing the law). Many other aspects of the law, however, such as the mechanism for cashing out minority shareholders, streamlined takeovers, prompting legal practitioners to describe the law as "a critical step toward a fairer, more open environment for potential acquirors of German public companies," which "appears to signal foreign investors that German capital markets are now ready to treat unsolicited tender offers, sophisticated LBOs and other going-private transactions as routine." *See* New German Takeover Scheme: Shaping Germany's Market for Corporate Control Skadden Arps Slate Meagher & Flom Memorandum to Clients, Apr. 2002), http://www.skadden.com/content/publications/809library.pdf.

[52] *See Viertes Finanzmarktförderungsgesetz* [Fourth Financial Market Promotion Act] of Jun. 21, 2002, BGBl. I (2002), 2010; Nowak, *supra* note 43, at 439-40.

[53] *See Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität (TransPuG)* [Law for further Reform of Stock and Accounting Law to Achieve Transparency and Publicity] of Jul. 19, 2002, BGBl. I (2002), 2681.

[54] *See Gesetz zur Verbesserung des Anlegerschutzes (AnSVG)* [Law for Improving Investor Protection] of Oct. 24, 2004, BGBl. I (2004), 2630.

[55] *See* BT-Drs. 15/5091 (Mar. 14, 2005), *Entwurf eines Gesetzes zur Einführung von Kapitalanleger-Musterverfahren (KapMuG)* [Bill on Shareholder Class Actions], http://dip.bundestag.de/btd/15/050/1505091.pdf.

[56] *See* BT-Drs. 15/5092 (Mar. 14, 2005), *Entwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG)* [Bill on Corporate Integrity and Modernization of Litigation Rights], http://dip.bundestag.de/btd/15/050/1505092.pdf.

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

reforms responded to corporate failures that were blamed on bank-dominated corporate boards asleep at the switch.[58] The reforms also were part of a transition to shareholder capitalism signaled by the ambitious privatization of Deutsche Telekom in 1996.[59] And, with the German government's effort to overhaul the country's ailing pension system in 2001 by encouraging private saving for retirement, the reforms raised the profile of the stock market as a viable avenue for investment.[60] All of these objectives pushed lawmakers to meet shareholder demands.

Consider, for example, the corporate governance code that public companies were required to follow.[61] The code was the work of a commission formed by the German government to propose methods to modernize its corporate law in light of the globalization of capital markets.[62] The commission did not disband after handing over its report. It continues to periodically revise the corporate governance code, and maintains an informative website in five languages on corporate governance in Germany.[63] The multilingual site fits the

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order to boost growth, which was flat in 2003").

[58] *See* Jeffrey N. Gordon, Pathways to Corporate Governance? Two Steps on the Road to Shareholder Capitalism in Germany, 5 Colum. J. Eur. L. 219, 220-21 (1999) (describing the board failures at Daimler-Benz, Metallgesellschaft, Schneider, and Klöckner-Homboldt-Deutz that precipitated the 1998 reform); Nowak, *supra* note 43, at 433-34, 438-39 (noting that the 2002 reform was partly a response to the scandals that had brought down in 2001 the four-year old stock exchange for technology firms, Neuer Markt).

[59] *See* Jeffrey N. Gordon, An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000 (European Corporate Governance Institute Law Discussion Paper No. 6/2003; Harvard Law and Economics Discussion Paper No. 406, Feb. 2003), http://ssrn.com/abstract=374620 (linking the expansion of stock ownership in public companies, the launch of a stock trading platform for young companies, the tightening of legal protection of shareholders, and the growing acceptance of a market for corporate control to the privatization of Deutsche Telekom in 1996).

[60] *See* Stuart Vitols, Changes in Germany's Bank-Based Financial System: Implications for Corporate Governance, 13 Corp. Gov. 386, 390 (2005).

[61] *See supra* note 53 and accompanying text.

[62] According to a government bill based on the commission's recommendations, the commission "was asked to consider changes in [Germany's] corporate and market structures caused by globalization and internationalization of capital markets in order to propose how to modernize [Germany's] law." *See* BT-Drs. 14/8769 (Apr. 11, 2002), at 10, http://dip.bundestag.de/btd/14/087/1408769.pdf ("*[S]ollte sie im Hinblick auf den durch Globalisierung und Internationalisierung der Kapitalmärkte sich vollziehenden Wandel unserer Unternehmens- und Marktstrukturen Vorschläge für eine Modernisierung unseres rechtlichen Regelwerkes unterbreiten.*").

[63] *See* Government Commission of the German Corporate Governance Code, http://www.corporate-governance-code.de/index-e.html. The corporate governance has thus far been amended twice. *See* http://www.corporate-governance-code.de/eng/archiv/

purpose of the code. "The aim of the German Corporate Governance Code," the site explains, "is to make Germany's corporate governance rules transparent for both national and international investors, thus strengthening confidence in the management of German corporations."[64] The same objective underlies the pending bill on derivative suits.[65] Here too, according to the financial press, there is no doubt about the motivation for reform:

> [A]s corporate Germany opens its shareholder registers to the world, the government has realised the old order has to change. It is rushing a vast package of reforms through parliament to overhaul companies' relations with investors.[66]

The transformation of Italian corporate law began in 1990 with the Amato Law, named after the treasury minister who sponsored it, which incorporated all state-controlled banks in preparation for their privatization.[67] It was followed in 1992 by the conversion of other state-controlled businesses to corporations.[68] The privatization plan had two objectives, both related to the economic integration of the European Union. The first objective was to facilitate the consolidation of the Italian industry in order to compete with foreign businesses.[69] The second objective was to lower the national deficit in order to qualify for admission into the euro system pursuant to the Treaty of Maastricht.[70]

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index.html.

[64] *See* http://www.corporate-governance-code.de/index-e.html. This is consistent with the government bill that introduced the 2002 law, which stated that, "especially for informing foreign investors, it appeared inevitable to adopt a corporate governance code for Germany." *See* BT-Drs. 14/8769, *supra* note 62, at 21 (*"Gerade im Hinblick auf die Information ausländischer Anleger erschien es unvermeidlich, einen maßgebenden Corporate-Governance-Kodex für Deutschland zu initiieren."*).

[65] *See supra* note 54.

[66] Bertrand Benoit & Patrick Jenkins, Germany Looks to Call Time on Its Business War Games, Fin. Times, Dec. 30, 2004, at 32.

[67] See L. 30-7-1990, n. 218, "Disposizioni in materia di ristrutturazione e integrazione patrimoniale degli istituti di credito di diritto pubblico" [Provisions Related to Restructuring and Integration of Credit Institutions under Public Law].

[68] *See* Deeg, supra note 41, at 187. The need to compete with foreign banks resulted from the European Union Investment Services Directive, which required member states to allow foreign banks to operate in them. *See id.*

[69] See id.

[70] *See, e.g.*, Romano Prodi, Italy's Would-Be Record-Breaker, Economist, Oct. 10, 1998, at 58 (noting that Italian prime minister Prodi, formerly an economics professor, "pushed ahead with privatisation . . . liberalised shopping hours and licences, tried to shake the fat out of the economy, made bureaucrats jump" to meet the euro qualification criteria); Niccolo d'Aquino, Italy Prepares for EMU, Europe, Jul.-Aug. 1997, at 14 (noting that Italy's ability to meet the euro qualification criteria is "repeated everyday in the newspapers," that the prime minister and his coalition members "are betting all their international — and a

The privatizations started in 1993 and peeked in 1997 with the public offering of Telecom Italia and Borsa Italiana.[71] In the same year, the government formed a committee to draft a new public-company law and appointed the commissioner of privatizations, Mario Draghi, as its chair. The resulting legislation, enacted in 1998, revamped the law governing public companies. Coming at the heels of a recent tax reform to encourage public equity offerings,[72] it introduced new disclosure obligations, strengthened shareholder rights, facilitated voting by proxy, and expanded the enforcement power of the securities authority.[73] The following years saw further legislation — in the form of a 2001 law and four decrees to implement it — vastly expanding the flexibility both public and private companies have in financing and structuring their operations.[74] Among other things, the legislation

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great deal of their national — credibility on whether or not they can do it," and that "what counts most is the first and most important parameter: the percentage of the public deficit with regard to the gross national product").

[71] *See* Deeg, *supra* note 41, at 188. In addition to adding the public float on the market, the privatization of Borsa Italiana created a powerful new supporter of corporate reform. *See id.*

[72] *See* Paul Betts, Market 'Half the Size It Should Be', Fin. Times, Dec. 10, 1997, at 2.

[73] *See* Deeg, *supra* note 41, at 188; Guido A. Ferrarini, Corporate Governance Changes in the 20 Century: A View from Italy, *in* Changes of Governance in Europe, Japan and the US (Theodore Baums, Klaus J. Hopt & Katrina Pistor eds., forthcoming 2005) / Corporations, States, Markets and Intermediaries: Changes of Governance in Europe, Japan and the USA (Harald Baum, Klaus Hopt, Hideki Kanda & Eddy Wymeersch eds., forthcoming 2005); Alexander Aganin & Paolo Volpin, The History of Corporate Ownership in Italy, *in* The History of Corporate Ownership (Randall Morck ed., forthcoming 2005).

[74] See L. 3-10-2001, n. 366, "Delega al Governo per la riforma del diritto societario," Gazz. Uff. 234 (Oct. 8, 2001) ["Delegation to the Government of the Reform of Corporate Law"); D. Leg. 11-4-2002, n. 61, "Disciplina degli illeciti penali e amministrativi riguardanti le societa' commerciali, a norma dell'articolo 11 della legge 3 ottobre 2001, n. 366," Gazz. Uff. 88 (Apr. 15, 2002) ["Regulation of Criminal and Administrative Actions Concerning Corporations under Article 11 of Law No. 366 of October 3, 2001"]; D. Leg. 17-1-2003, n. 5, "Definizione dei procedimenti in materia di diritto societario e intermediazione finanziaria, nonché in materia bancaria e cretidizia," Gazz. Uff. 17, Supp. Ord. 8 (Jan. 22, 2003) ["Definitions of Proceedings Related to Corporate and Financial Intermediation Law and to Banks and Credit Institutions"]; D. Leg. 17-1-2003, n. 6, "Riforma organica della disciplina delle società di capitali e società cooperative, in attuazione della legge 3 ottobre 2001, n. 366," Gazz. Uff. 17, Supp. Ord. 8 (Jan. 22, 2003) ["Reform of the Regulation of Public Corporations and Cooperatives Implementing Law No. 366 of October 3, 2001"]; D. Leg. 6-2-2004, n. 37, "Modifiche ed integrazioni ai decreti legislativi numeri 5 e 6 del 17 gennaio 2003, recanti la riforma del diritto societario, nonché al testo unico delle leggi in materia bancaria e creditizia, di cui al decreto legislativo n. 385 del 1° settembre 1993, e al testo unico dell'intermediazione finanziaria di cui al decreto legislativo n. 58 del 24 febbraio 1998," Gazz. Uff. 37, Supp. Ord. 24 (Feb. 14, 2004) ["Modifications and Integrations of Legislative Decrees Nos. 5 and 6 of January 17, 2003 Implementing the Reform of Corpo-

allowed for different board structures, limited the ability of shareholders to bring strike suits, authorized the issuance of preferred stock, redeemable stock, tracking stock, bonds of any kind, and hybrid securities; and facilitated shareholder voting.[75] To Italian commentators it is obvious that all these changes were "expressly inspired by comparative analysis in that a number of new governance and financing options for Italian companies were borrowed or 'transplanted' from other systems."[76] But the changes were not meant to attract incorporations. Rather, in the words of one Italian treasury official, their objective was:

> to enhance the competitiveness of Italian companies and enhance their efficiency and their ability to grow in an increasingly competitive environment, working on the assumption that global competition not only involves a country's economic conditions, but also the legal system in which companies operate. For when investors decide how to allocate the resources they manage, they assess both the economic factors and the reliability and accountability of the legal system, as well as the management of individual companies.[77]

These words are echoed in the law authorizing the decrees itself, which states as its goal "to pursue the foremost objective of promoting the birth, the growth, and the competitiveness of enterprises through

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rate Law, of the Rules Relating to Banks and Credit Institutions in Legislative Decree No. 385 of September 1, 1993, and of the Rules Relating to Financial Intermediaries in Legislative Decree No. 58 of February 24, 1998"].

[75] For a detailed discussion of the reforms, see Ferrarini, Guidici, & Richeter; *see also* European M&A Report, Cleary, Gottlieb, Steen & Hamilton Memorandum to Clients (Dec. 2004), http://www.cgsh.com/files/tbl_s47Details/FileUpload265/199/CGSH%20European%20M&A%20Report%203Q%202004.pdf (describing the liberalization of corporate capital structure).

[76] *See* Marco Ventoruzzo, Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition, 40 Tex. Int'l L.J. 113 (2004); Guido Ferrarini, Paolo Giudici & Mario Stella Richter, Company Law Reform in Italy: Real Progress?, *in* Company Law and Corporate Governance in Europe (Max-Planck Institut, forthcoming 2005).

[77] Roberto Ulissi, Company Law Reform in Italy: An Overview of Current, *in* Conference on Company Law Reform in OECD Countries: Comparative Outlook of Current Trends (Stockholm, 7-8 Dec. 2000), http://www.oecd.org/dataoecd/21/32/1857507.pdf. Elsewhere, that author reiterates: "Making Italy a more attractive environment for investors can be considered the idea lying behind the reform initiatives: this meant revising securities, company and bankruptcy law. The judicial mechanism for enforcing shareholders' and creditors' rights also need to be improved." *See id.* Italian commentators agree. *See* Ferrarini, Giudici & Richter, *supra* note 76 (describing the reforms as "[d]irected at enhancing the creation of new business firms and the competitiveness of the same both with regards to product and capital markets.").

access to domestic and international capital markets."[78] With this purpose in mind, it is not surprising to find a summary of the new rules by the Italian department for foreign investment, development, and internationalization on the website of the Italian embassy in the United States under the heading, "Do You Want to Invest in Italy?"[79] Presently, the Italian parliament is considering a bill drafted after the collapse of dairy producer Parmalat in 2003.[80] The conceptual framework of the bill is reminiscent of legislation introduced in the United States in the wake of the Enron debacle two years earlier.[81] But Italy's lawmakers have different motives to push for these reforms. Whereas, the American legislation has been viewed as a political reflex to placate domestic citizens with little concern for how foreign issuers would react to the changes, [82] the Italian bill has been seen as an attempt to repair the country's reputation among investors.[83]

The development of French corporate law is also linked to the massive privatizations that started in 1986 and increased the dependence of the economy on equity markets. The reform's opening shot was fired in 1984 with a law enhancing the independence of corporate auditors.[84] Drawing political force from two financial scandals involving state-owned aluminum company Pechiney and recently privatized bank Société Générale, the reform continued with a 1988 law that expanded the enforcement powers of the country's securities agency, created two additional securities agencies, and imposed new disclosure, manipulation, and insider-trading rules. A 1989 law further

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[78] See L. 3-10-2001 n. 366, § 2(1), supra note 74 ("La riforma del sistema delle società di capitali . . . è ispirata ai . . . perseguire l'obiettivo prioritario di favorire la nascita, la crescita e la competitività delle imprese, anche attraverso il loro accesso ai mercati interni e internazionali dei capitali.").

[79] *See* Embassy of Italy in the United States, Do You Want to Invest in Italy?, http://www.italyemb.org/Invest.htm.

[80] *See* Robert Galbraith, Italian Parliament Stalls Rise of Audit Committees, The Accountant, Aug. 26, 2004, at 11.

[81] *See* Paolo Montalenti, The New Italian Corporate Law: An Outline, 1 Eur. Corp. L. & Fin. Rev. 368 (2004).

[82] *See* Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L.J. 1521 (2005).

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

[84] *See* James A. Fanto, The Role of Corporate Law in the Adaptation of French Enterprises, 1998 Colum. L. Rev. 97, 112.

strengthened the enforcement powers of the primary securities agency.[85] The next step was a 2001 law which improved corporate disclosure, facilitated shareholder litigation, enhanced shareholder protection in takeovers, and allowed companies to separate the roles of chief executive officer and chair of the board.[86] The government-commissioned report on which the reform was based was clear about its motivation:

> Economic competition also puts in competition legal systems. From this perspective, the heavy-handedness and rigidities of French corporate law are a handicap. Among the considerations taken into account in the choice of the host country for a commercial company, the adaptability of the law to the specific needs of the company and to changes in the economic and social environment is undoubtedly an important factor.[87]

In 2003, another law came into effect in France which transformed three corporate regulators with shared responsibilities into a single body.[88] According to French lawyers, one of the goals of the change

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[85] *See* Note, Leslie A. Goldman, The Modernization of the French Securities Markets: Making the EEC Connection, 60 Fordham L. Rev. 227, 238-40 (1992).

[86] *See Loi no. 2001-420 du 15 mai 2001 relative aux nouvelle regulations économiques,* [Law No. 2001-420 of May 15, 2001 Relating the New Economic Regulations] J.O. 7776 (May 16, 2001), http://www.legifrance.gouv.fr/texteconsolide/ADEEM.htm.

[87] Phillipe Marini, *Rapport au Premier minister: La Modernisation du Droit des Sociétés* 20 (La documentation Française, Jul. 13, 1996) [Report to the Prime Minister on the Modernization of Corporate Law] (*"[L]a compétition économique met également en concurrence les systèmes juridiques. De ce point de vue, la lourdeur et les rigidités du droit français des sociétés constituent un handicap. Parmi les éléments pris en considération dans le choix du pays d'accueil d'une société commerciale, nul doute que la faculté d'adaptation de l'instrument juridique aux besoins spécifiques de l'entreprise et aux modifications de l'environment économique et social soit un factuer important."*); *see also id.* at 6 (*"[I]l faut à présent envisager d'assurer la compétitivité juridique de la France par rappprt aux systèmes d'inspiration anglo-saxonne d'un côté et germanique de l'autre, dans le contexte de marchés financiers totalement interconnectés et d'une liberté de plus en plus large de localisation des activités économiques."* ["It is now necessary to plan to ensure the legal competitiveness of France relative to Anglo-American systems on the one hand and German systems on the other hand, in the context of completely inter-connected financial markets and increasingly broad freedom where to place economic activity."]); *id.* at 9 (*"Aujourd'hui, les impératifs de l'ouverture internationale et la nécessité pour nos enterprises d'évoluer dans un cadre juridique compétitif semblent appeler une remise en cause de ce modèle afin de laisser plus de place à la liberté contractuelle."* ["Today, the requirements of the international opening and the need for our enterprises to evolve in a competitive legal environment seem to call into question [the rigid structure of the existing French corporate law] in order to leave more room for contractual freedom."]).

[88] *See Loi no. 2003-706 de sécurité financière du 1er août 2003* [Law No. 2003-706 of Aug. 1, 2003 on Financial Security], J.O. 13220 (Aug. 2, 2003).

was to "help restore investors' confidence in the financial markets in the wake of recent U.S. and European financial scandals."[89] Confidence in the market, however, was not all that mattered, if the goal was to attract investments rather than merely to appease the public. Investments required flexibility alongside shareholder protection. And flexibility is what the legislature sought to provide in an ordinance signed by the French president in 2004.[90] That ordinance, which has the force of law, removes procedural constraints on seasoned stock offerings, enables issuers to define the terms of preferred stock, and simplifies the treatment of convertible stock.[91] It is neither driven by scandal nor designed to reign in renegade managers. But it is nevertheless what investors want.

In 1998, the British department of trade and industry commissioned a comprehensive review of the country's corporate law. Some commentators argue that this British initiative is evidence of competition for incorporations.[92] It is not. It is evidence of competition for investments. Its self-proclaimed aim is "to develop a simple, modern, efficient and cost effective framework for carrying out business activity in Britain for the twenty-first century."[93] And while the initiative

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[89] *See* Nicolas Bombrun & François Mary, France, *in* The International Financial Law Review Guide to Mergers and Acquisitions 2004, http://www.legalmediagroup.com/IFLR/includes/print.asp?SID=5243.

[90] See Ordonnance no. 2004-604 du 24 juin 2004 portant réforme du régime des valeurs mobilières émises par les sociétés commerciales [Ordinance No. 2004-604 of Jun. 24, 2004 Implementing the Reform of Securities Law], J.O. 11612 (Jun. 26, 2004).

[91] *See* France Adopts New Legislation to Modernize Its Securities Laws, Cleary, Gottlieb, Steen & Hamilton Memorandum to Clients (Jul. 8, 2004), http://www.cgsh.com/files/tbl_s5096AlertMemoranda%5CFileUpload5741%5C188%5C55-2004.pdf.

[92] *See, e.g.*, Gerard Hertig & Joseph A. McCahery, The U.S. Concept of Granting Corporations Free Choice among State Corporate Law Regimes as a Model for the European Community, 4 Eur. Bus. Org. L. Rev. 179, 186 (2003); Joseph A. McCahery & Erik P.M. Vermeulen, The Evolution of Closely Held Business Forms in Europe, 26 J. Corp. L. 855, 875 (2001); Deakin, *supra* note 5, at 205.

[93] *See* Department of Trade and Industry, Corporate Law and Governance: Modernising Company Law, http://www.dti.gov.uk/cld/review.htm. The reform was presented as part of a broader policy of economic development, which included in an earlier stage steps to "[create] the conditions for macro-economic stability" by "[ensuring the country's] public finances were put in order" and "[giving] independence to the Bank of England so that decisions on interest rates were taken for economic rather than political reasons," thereby "providing business with the foundations for growth and consumers with low prices and competitive markets," and setting the stage for "promoting enterprise and raising productivity" by fitting corporate law "for the twenty-first century and beyond." *See* Preface by the Secretary of State, Modernising Company Law, Command Paper CM 5553, at 3 (Jul. 2002), http://www.dti.gov.uk/companiesbill/prelims.pdf. *See also* Kevin Brown & Michael Peel,

originally highlighted "small private companies" that constitute the majority of the "1.5 million companies in Great Britain,"[94] the reforms that the government has adopted since the beginning of the process target public companies, which are more relevant to internationally mobile capital.[95] These reforms include regulations from 2002 that require public companies to disclose executive compensation and have shareholders approve it,[96] an act from 2004 that strengthens the audit of public companies while expanding the power of companies to indemnify directors for liability,[97] and proposed regulations from 2004 that require public companies to disclose more fully their performance and business risks.[98]

Blueprint to Help Bring Business 'Into the 21st Century', Fin. Times, Jul. 27, 2001 (reporting that the trade and industry secretary explained the need for the reform by saying that "UK company law, once regarded as the best in the world, has fallen well behind that of other countries" and that "[y]ears of neglect have left us with an archaic Victorian system that is holding British business back."). Consistently, the reform project received strong support from industry group. *See* Brown & Peel, *supra* note 93 (reporting that supporters of the reform included the Institute of Directors and the Trade Union Congress).

94 *See* The Government Policy, Modernising Company Law, Command Paper CM 5553, at 15-16 (Jul. 2002), http://www.dti.gov.uk/companiesbill/part2.pdf.

95 *See* Eilís V. Ferran, Company Law Reform in the UK: A Progress Report, *in* Company Law and Corporate Governance in Europe (Max-Planck Institute, forthcoming 2005). The delay of other parts of the reform was heavily criticized by representatives of the local industry. *See* Andrew Parker, Delay on Company Law Reform Attached, Fin. Times, Jul. 11, 2003, at 4 (noting that industry organizations such as the Confederation of British Industry and the Federation of Small Businesses attacked the government for delaying the corporate law reform, and that the member of the opposition party who serves as shadow trade and industry said that "the government's failure to proceed with a swift overhaul of company law undermined its pro-business stance.").

96 *See* Directors' Remuneration Report Regulations 2002, S.I. 2002/1986, http://www.legislation.hmso.gov.uk/si/si2002/20021986.htm.

97 *See* Companies (Audit, Investigations and Community Enterprise) Act 2004, http://www.legislation.hmso.gov.uk/acts/acts2004.htm. According to the official notes to the act, it "forms part of the Government's strategy to help restore investor confidence in companies and financial markets following recent major corporate failures." *See* Explanatory Notes to Companies (Audit, Investigations And Community Enterprise) Act 2004, § 4, http://www.legislation.hmso.gov.uk/acts/expa2004.htm.

98 *See* Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2004 (draft), *in* Department of Trade and Industry, Draft Regulations on the Operating and Financial Review and Directors' Report: A Consultative Document (May 2004), http://www.dti.gov.uk/cld/pdfs/ofr_condoc.pdf. For the current draft of the proposed regulations, see Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005, (draft), http://www.legislation.hmso.gov.uk/si/si2002/20021986.htm.

Examples from other member states abound.[99] In 1999, for example, a takeover law modeled after the British City Code on Takeovers, which prohibits managers from thwarting unsolicited public tender offers, came into effect in Austria. The law was not meant to attract incorporations. Accordingly, it applies only to target companies located and listed in Austria.[100] Similarly, in 2004, a bill was introduced in the Dutch parliament setting forth new requirements regarding the election of directors, shareholder approval for major corporate changes, shareholder proposals, and voting by holders of share depository receipts. The impetus for the reform was not a government plan to attract foreign incorporations, but rather the public uproar over a series of major domestic bankruptcies, financial scandals, and lavish executive compensation packages.[101] The proposal was nonetheless informed by solutions developed elsewhere in the world to handle similar problems. In particular, the reforms seemed to reflect increasing sensitivity in the accountancy profession to the need for independence in conducting corporate audits "due to international developments (the Sarbanes-Oxley Act, IAS/IFRS, and various financial scandals such as Enron, Parmalat and Ahold)."[102]

Finally consider voluntary codes of corporate governance. By the end of 2001, there were no less than thirty-five codes setting similar best practices of corporate governance in the various member states of the European Union. Twenty-five of these codes were issued after 1997.[103] Subsequent years saw the introduction of additional voluntary codes. They too resembled each other in their handling of executive compensation, financial auditing, and public disclosure.[104]

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[99] For a survey of corporate reforms in 21 European countries prepared for the British department of trade and industry, see Company Law in Europe: Recent Developments (Feb. 1999), http://www.dti.gov.uk/cld/milman.pdf.

[100] *See* Nick Callister-Radcliffe et al., Rejection of the EU Takeover Directive — The Implications, Int'l Bus. Law., Sept. 2001, at 338, 339-40; *see also* Peter M. Polak, Austria, *in* The International Financial Law Review Guide to Mergers and Acquisitions 2004, http://www.legalmediagroup.com/IFLR/includes/print.asp?SID=5232.

[101] *See* Jan Louis Burggraff & Joyce Winnubst, The Netherlands, *in* The International Financial Law Review Guide to Mergers and Acquisitions 2004, http://www. legalmediagroup.com/IFLR/includes/print.asp?SID=5250.

[102] *See* Burggraff & Winnubst, *id.*

[103] *See* Weil, Gotshal & Manges, Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States 2 (Jan. 2002), http://europa.eu.int/comm/internal_market/en/company/company/news/corp-gov-codes-rpt_en.htm.

[104] See id.

The legal innovation and diffusion in these examples is not the product of competition for incorporations. Even commentators who predict such competition in the European Union in the future acknowledge its absence today and regard large industrialized member states as unlikely candidates for spearheading it. Yet it was these member states that seem to have adopted the most sweeping legal reforms. Far from trying to win new incorporations, or trying not to lose existing ones — neither of which can motivate laws applicable only to local businesses — member states modified their laws so as to attract investments in their economies. Sometimes they innovated. Often they borrowed from others.[105]

II. The Incentives to Compete

The ability and willingness of corporate decisionmakers to shop for laws is not enough of a driver for regulatory competition to develop. Another key condition is a desire by lawmakers to respond. But this condition is not easily met. In the United States, birthplace of the competition-for-incorporations theory, only Delaware pursues incorporations by foreign firms. Other states, by some accounts, make far weaker efforts to retain incorporations by local firms. By other accounts, they do not compete at all. In contrast, the incentives to compete for investments can be strong because the rewards of such competition are high and because these rewards accrue to all competitors rather than to only one. The integration of the markets for capital, products, and labor in recent years has set the stage for this competition to develop in the European Union. The resulting dramatic re-

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[105] In some cases, member states copied foreign law specifically at the request of local companies. Germany, for example, passed in 1998 a law (*Kapitalaufnahmeerleichterungsgesetz*, or KapAEG) that allows companies to balance their books using international or American accounting standards in order to enable them to list their stock overseas without having to prepare two sets of financial statements. *See* Eric Nowak, Recent Developments in German Capital Markets and Corporate Governance, 14 J. Applied Corp. Fin. 35, 44 (2001) (linking the legislation to the listing of Daimler Benz in the United States as part of its merger with Chrysler). For illustration of the two sets of financial statements that used to be filed by German companies listed in the United States prior to the change, see Deutsche Telekom Consolidated Financial Statements for 1996, at 61-62, available at http://download-dtag.t-online.de/englisch/investor-relations/4-financial-reports/annual-reports/1996/abschluss.pdf. Germany also changed its law in 1998 under pressure from corporate managers and investment banks to allow the use of stock option compensation as in the United States. *See* Telephone Interview with Joachim von Falkenhausen, Partner, Latham & Watkins LLP, Hamburg, Jun. 28, 2004 [hereinafter von Falkenhausen Interview].

sponse by member states leaves no doubt about the potential of competition for investments to shape corporate law. Quite apparently, the potential is high.

A. Benefits

An important reason why competition for investments thrives where competition for incorporation might fail to get the attention of lawmakers is that its stakes are higher and its rewards are more suitable to becoming part of a political platform.[106]

1. Competition for Incorporations

Much has been said about the lure of the fiscal gains a jurisdiction can earn from incorporations by foreign companies and about the profits its legal community can reap from providing services to these companies. In reality, however, only jurisdictions with limited financial means can be driven at all by the possible fiscal gains from incorporations. And the legal community, as enthusiastic as it may be about attracting incorporations, will need to point to significant gains accruing to the entire polity in order to motivate lawmakers to adopt corporate legislation that could face significant opposition.

It is difficult to estimate the potential of incorporations as a source of tax revenue. Any such estimate depends on the number of incorporated firms, their need of corporate law, and the alternatives available to them elsewhere.[107] It is easy, however, to observe the experience

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[106] Another difference between competition for incorporations and competition for investments is that only the former can theoretically be replicated by private actors. The politics involved in any public lawmaking have led commentators to conclude that private actors competing for incorporations would produce better corporate law than would elected officials. *See* Gillian Hadfield & Eric Talley, On Public versus Private Provision of Corporate Law (University of Southern California Center in Law, Economics and Organization Research Paper C04-13, Jun. 2004). Private actors, however, cannot capture the gains from economic development, and thus they cannot replicate the competition for investments.

[107] Member states do not have to tax incorporations directly. They can also, for example, tax the use of their courts or legal services by chartered firms. But these indirect taxes may not yield higher revenues. Court fees, which are meaningful only in legal regimes that rely on litigation, are borne by shareholder plaintiffs, rather than chartered companies. Indeed, Delaware, which relies heavily on courts in the administration of corporate law, imposes no such fees. Similarly, legal services taxes are borne only by firms that use local legal services, and can easily be avoided by using foreign legal services. More generally, it is fair to assume that decades of experimentation have brought Delaware close to optimizing its incorporation tax subject to political constraints. A new competing member state in the

that Delaware has had in this regard. Delaware is a success story. It stands in the enviable position of attracting half the public companies in the United States,[108] and almost all public companies that incorporate outside their home state,[109] with virtually no political costs and only minimal financial costs. The result? A respectable tax revenue of $523 million forecasted for 2005 on budgeted outlays of $15 million, constituting a fifth of the state's total revenue.[110]

But this American dream may remain out of reach for member states of the European Union even as the freedom to choose where to incorporate reaches their shores. Taxing incorporated firms more than the cost of servicing them is simply not allowed under European Union law.[111] Not that such a tax would make a big difference anyhow. In 2003, gross domestic product in the United States was $10.9 trillion. The equivalent figure for the European Union was $8.2 trillion.[112] Domestic stock market capitalization in the United States in that year was more than $14 trillion. The corresponding figure for the European Union was $8 trillion.[113] Even if a single member state assumed overnight a position similar to the one enjoyed by Delaware, its tax revenue from incorporations would probably be lower because it would

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European Union is unlikely to derive significantly higher gains from a similar market.

[108] *See* Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. Pa. L. Rev. 1795, 1813 (2002) (examining Delaware's share of American public companies in 2000). Delaware public companies also tend to be bigger than other public companies. While constituting half the public companies in the sample, they account for 59% of net sales. *See id.*

[109] *See* Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. Rev. 1563, 1563 (2002) (examining Delaware's share of initial public offerings in the United States between 1978 and 2000); Lucian Arye Becbchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J.L. & Econ. 383 (2003) (examining Delaware's share of public companies in the United States).

[110] *See* An Act Making Appropriations for the Expense of the State Government for the Fiscal Year Ending June 30, 2005, S.B. 320, 142nd Leg. (Del. 2004), http://www.state.de.us/budget/budget/ fy2005/fy2005-sb320-budget-bill.pdf.

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

[112] *See* World Bank, Data & Analysis, http://www.worldbank.org/data/countrydata/countrydata.html (comparing data from the stock exchanges of Athens, Borsa Italiana, Budapest, Copenhagen, Deutsche Börse, Euronext, Helsinki, Ireland, Ljubljana, London, Luxembourg, Malta, Oslo, Spanish Exchanges (BME), Stockholm, Warsaw, and Wiener Börse in the European Union, and Amex, Nasdaq, and New York in the United States).

[113] *See* World Federation of Exchanges, Domestic Equity Markets, http://www.world-exchanges.org/WFE/home.asp?menu=315&document=2490 (reporting stock market capitalization of domestic companies by stock exchange).

command a smaller market.[114] This revenue might be significant for some of the smallest member states. But, as the following Section will explain, these member states lack the necessary legal infrastructure to attract the sort of large public companies that can generate such revenue.[115]

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

Two factors explain the ease with which the Delaware corporate bar routinely pushes its proposals through the state legislative process. The first is the absence of any interest group in the state that might object to these proposals. The second is the state's reliance on the fiscal gains from incorporations.[116] Delaware lawyers, to be sure, gain handsomely from their state's thriving incorporations business.[117] But so does the state. It reaps fiscal gains from incorporations that pay for a fifth of its public consumption with minimal political and economic costs, placing it second nationally in revenue per capita.[118] With this symbiotic relation between local lawyers, politicians, and the state government, it is no wonder that corporate lawyers in Delaware get their way.

By comparison, corporate lawyers in other states have a much harder time pushing legislation to attract incorporations — precisely because interest groups exist in these states that resist their initiatives. It was politics, not the lack of support from corporate lawyers, that derailed a Pennsylvania effort to form a juryless corporate tribunal with judges appointed based on merit.[119] Politics also derailed an effort

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[114] *See* Miccoli, *supra* note 15 (describing as unrealistic the possibility that member states would compete for incorporations by companies that operate and pay income tax elsewhere).

[115] *See infra* Section II.B.1.

[116] *See* Roberta Romano, The Genius of American Corporate Law 60 (1993) (arguing that Delaware corporate law is little affected by partisan lobbying because most Delaware companies operate outside the state).

[117] *See* Kahan & Kamar, *supra* note 1, at 694-98 (estimating the net profit per Delaware lawyer from incorporations at roughly $35,000 a year in 2000).

[118] *See* U.S. Census Bureau, State Rankings — Statistical Abstract of the United States: State Government General Revenue Per Capita 2002, http://www.census.gov/statab/ranks/rank24.html.

[119] *See* John L. Kennedy, Chancery Ct. Plan Sent to Senate, Legal Intelligencer, May

to form a Nevada corporate tribunal without juries and with judges that do not rotate.[120] The lesson from these experiences is clear: It is not enough that corporate lawyers want the legislation to pass; if they are to overcome political objections, the public benefits to the state and the political benefits to lawmakers must at least appear significant.

2. Competition for Investments

Capital investments fuel economic development. The direct effect of capital investments on growth is obvious. Indirectly, however, capital investments stimulate growth also by deepening domestic stock markets,[121] which serve as an outlet for selling startup companies,[122] allocating funds to well-performing firms,[123] and facilitating corporate restructuring through mergers.[124] This insight has not been lost on policymakers. Italian policymakers, for example, have acknowledged

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17, 1993, at 1.

[120] *See* Minutes of the Nev. Legis. Commission's Subcomm. to Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State, 1999 Leg. 1999-2000 Interim Sess. (May 30, 2000) (testimony of A. William Maupin, Associate Justice, Supreme Court of Nevada).

[121] *See* P.L. Rousseau & P. Wachtel, Equity Markets and Growth: Cross-Country Evidence on Timing and Outcomes, 1980-1995, 24 J. Banking & Fin. 1933 (2000) (finding that liquid stock markets promote economic growth); Asli Demigrüç-Kunt & Vojislav Maksimovic, Law, Finance, and Firm Growth, 53 J. Fin. 2107 (1998) (finding that active stock markets are associated with externally financed firm growth); Ross Levine & Sara Zervos, Stock Markets, Banks, and Economic Growth, 88 Am. Econ. Rev. 537 (1998) (finding that stock market liquidity predicts growth, capital accumulation, and productivity improvements). For the link between corporate law and stock markets, see Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997) (finding that countries that protect shareholders have more valuable stock markets, larger numbers of listed securities per capita, and a higher ratio of initial public offerings than other countries).

[122] *See* Wendy Carlin & Colin Meyer, How Do Financial Systems Affect Economic Perfromance?, *in* Corporate Governance: Theoretical and Empirical Perspectives 137 (Xavier Vives ed. 2000) (finding that equity markets are associated with national economic growth through research and development).

[123] *See* Jeffrey Wurgler, Financial Markets and the Allocation of Capital, 58 J. Fin. Econ. 187 (2000) (finding that investor protection and developed stock markets improve capital allocation).

[124] *See* Stefano Rossi & Paolo F. Volpin, Cross-Country Determinants of Mergers and Acquisitions, 74 J. Fin. Econ. 277 (2004) (finding that acquirers are based in countries with better corporate governance); Malcolm C. Baker, Fritz Foley & Jeffrey Wurgler, Stock Market Valuations and Foreign Direct Investment (Working Paper, Dec. 22, 2004), http://ssrn.com/abstract=556127 (finding that cross-border acquisitions increase with the current aggregate market-to-book ratio of the acquirer's stock market and decrease with subsequent returns on that market).

that "the growth of national industries does not depend only on their capacities for independent growth but also on the search for combinations with Italian or foreign partners, by means of mergers or stock swaps," and accordingly have endorsed "legislation that facilitates such consolidation by reducing the reorganization costs that integration between different company structures inevitably entails."[125]

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

One way these pressures have manifested themselves is in privatizations aimed at balancing the national budget and facilitating industry consolidation.[126] Privatizations motivate state officials to pay attention to the quality of corporate law for two reasons: First, during the privatization, quality law and liquid markets increase the revenue from selling shares of state-owned firms.[127] Second, after the privatization, maintaining the value of these shares is vital to the public trust in the government and the politicians associated with the privatization. The public outrage that can result from the mismanagement of a

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[125] *See* Draghi, *supra* note 36, at 356.

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

[127] A telling example is the success that American mutual fund Fidelity had in 1997 dissuading the French government from using its control over mining company Eramet to placate New Caledonian separatists by swapping one of the company's mines for an inferior one controlled by the separatists. It helped that the skirmish took place less than three months before a $7 billion initial public offering of France Telecom: All Fidelity had to do was to remind the French government that American investors would shun French privatizations if it did not back down. *See* Steinmetz & Sesit, *id.*

recently privatized firm may come back to haunt the politicians who backed the privatization.

In fact, a major corporate scandal can shake up the government even if it involves a company that was never state owned.[128] This too has been a common occurrence in the recent years, as can be expected in an economic downswing. To be sure, corporate scandals can precipitate reform independently of competition for investments. Indeed, much of federal securities legislation in the United States — including the Securities Act of 1933, the Securities Exchange Act of 1934, the Williams Act of 1968, and the Sarbanes-Oxley Act of 2002 — responded to perceived abuses that affected domestic investors. But corporate scandals carry with them an added penalty for countries that depend on mobile capital.[129] The knowledge that a scandal involving a single domestic company can taint the entire economy creates a strong incentive for lawmakers to adopt legislation that will prevent a scandal before it happens and, if one has already happened, to adopt legislation to prevent a reoccurrence.[130] If lawmakers have any doubt about their

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[128] This scenario is rather common even at an era of global capital markets because investors tend to invest locally to exploit information advantages. *See* Herald Hau, Location Matters: An Examination of Trading Profits, 56 J. Fin. 1959 (2001); Linda L. Tesar & Ingrid M. Werner, Home Bias and High Turnover, 14 J. Int'l Money & Finance 467 (1995); Ian Coopers & Evi Kaplanis, Home Bias in Equity Portfolios, Inflation Hedging, and International Capital Market Equilibrium, 7 Rev. Fin. Stud. 45 (1994); Thomas Gehrig, An Information Based Explanation of the Domestic Bias in International Equity Investment, 95 Scandinavian J. Econ. 97 (1993); Kenneth R. French & James M. Poterba, Investor Diversification and International Equity Markets, 81 Am. Econ. Rev. 222 (1991); *see generally* Andrew Karolyi & René Stulz, Are Financial Assets Priced Locally or Globally?, *in* The Handbook of the Economics of Finance (George M. Constantinides, Milton Harris & René M. Stulz eds., 2003).

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

[130] *See, e.g.*, Nicholas George, Fin. Times, Jan. 19, 2004, at 24 (quoting the Swedish minister for financial markets expressing disappointment with the failure of business leaders to take effective measures to restore the confidence in Swedish business, "which has been rocked by several corporate scandals, the most high-profile example involving huge bonus payments and management perks at the financial services group Skandia," and

responsibility, the financial press will quickly erase it, as the following article published after the collapse of Parmalat illustrates:

> Now, in Parmalat, an Italian food and milk-products company, Europe has a corporate scandal of truly Enronesque proportions. If the integrity of European business is to be restored, and public confidence in the continent's capital markets is to be sustained, Europe's response will have to be as determined and sweeping as America's. . .
>
> It has been tempting for international investors to think of Europe as a single investment space. The reality is that harmonisation of Europe's industrial and financial markets still has a long way to go. Local practices matter, never more so than when things go wrong. . .
>
> The danger to honest Italian business could not be clearer: their cost of capital will rise if investors begin to discriminate against a country that had been trying to shake off a reputation for dark dealings. In fact, this is precisely what international investors should now do. The sheer scale of the Parmalat scandal raises serious questions about Italian business practices which only a thorough, and very un-Italian, clean-up can now dispel.[131]

The link between legislation triggered by corporate scandals and competition for investments is evident when the scandals involve foreign companies and cannot be blamed on the local law. Unlike legislation triggered by local corporate scandals, which can be explained both as a response to public outcry and as an effort to shore up investor confidence in local companies, legislation triggered by foreign corporate scandals can only be explained by the latter. Foreign scandals have played a significant role in catalyzing reform in a number of European member states, sometimes even more so than local events. One such scandal was the 2002 collapse of the giant American corporation Enron amid accounting irregularities. The Enron scandal was followed closely in the European Union. In the United Kingdom, for example, the debacle prompted the government to accelerate and expand a preexisting plan for corporate reform, labeling its actions "post-Enron initiatives."[132] In Italy, the scandal similarly fueled calls

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expressing resolve to address the crisis in legislation if this failure continues).

[131] Turning Sour, Economist, Jan. 3, 2004; *see also* Richard Heller, Parmalat: A Particularly Italian Scandal, Forbes.com, Dec. 30, 2004, http://www.forbes.com/2003/12/30/cz_rh_1230parmalat_print.html ("Parmalat is reminiscent of several other florid Italian scandals, especially the Banco Ambrosiano affair. . . The Parmalat story simply does not fit into a global corporate-governance argument. It's beyond the pale; it's very Italian.").

[132] *See* Paul Davies, Post-Enron Developments in the United Kingdom, *in* Reforming Company and Takeover Law in Europe 185 (Guido Ferrarini, Klaus J. Hopt, Jaap Winter & Eddy Wymeersch eds., 2004) (documenting the legislative response in the United Kingdom to Enron); Department of Trade and Industry, Corporate Law and Governance: Post Enron Initiatives http://www.dti.gov.uk/cld/post_enron.htm.

for accounting reform.[133] Enron did not anger British or Italian voters; rather, it was a focusing event that reminded British and Italian lawmakers that their countries too could be hit by a similar scandal and lose their appeal to investors.[134] In the case of Italy, this fear took only two years to become a reality.

Lastly, capital investments strengthen the local financial services industry and solidify local financial centers which — in addition to being drivers of the national economy[135] — can be rather influential. The keen interest in helping the local financial industry compete internationally is a recurring motif in the legislative agenda of more than one member state. It has played an important role, for instance, in Italy, where reformers emphasized, under the heading "The Prospects of the Italian and European Stock Exchanges":

> The future of the European financial industry will see savings channeled towards the financial centres where they are most efficiently managed. Those centers will unfailingly become the places of greatest concentration of financial structures and infrastructure. An intensive planning effort will be necessary to avert the marginalization of the Italian financial in-

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[133] *See* Robert Galbraith, Disappointment and Dissatisfaction in Italy, The Accountant, Sept. 25, 2002, at 16 (reporting on stories of accounting scandals in the United States are fueling calls for accounting reforms in Italy).

[134] *See* John W. Kingdon, Agendas, Alternatives, and Public Policies 94 (2d ed. 1995) ("Problems are often not self-evident by the indicators. They need a little push to get the attention of people in an around government. That push is sometimes provided by a focusing event like a crisis or disaster that comes along to call attention to the problem, a powerful symbol that catches on, or the personal experience of a policy maker"); Thomas A. Birkland, An Introduction to the Policy Process 116 (2001) ("Focusing events are sudden, relatively rare events that spark intense media and public attention because of their sheer magnitude or, sometimes, because of the harm they reveal. Focusing events thus attract attention to issues that may have been relatively dormant. . . Focusing events can lead groups, government leaders, policy entrepreneurs, the news media, or members of the public to pay attention to new problems or pay greater attention to existing but dormant (in terms of their standing on the agenda) problems, and, potentially, can lead to a search for solutions in the wake of perceived policy failure.").

[135] The contribution of strong financial institutions to growth is well established. For recent studies, see Thorsten Beck, Ross Levine & Norman Loayza, Finance and the Sources of Growth, 58 J. Fin. Econ. 261 (2000) (finding that financial intermediaries increase factor productivity and gross domestic product growth); Raghuram G. Rajan & Luigi Zingales, Financial Dependence and Growth, 88 Am. Econ. Rev. 559 (1998) (finding that industrial sectors in need of external financing develop faster in countries with more developed financial markets); Klaus Neusser & Maurice Kugler, Manufacturing Growth and Financial Development: Evidence from OECD Countries, 80 Rev. Econ. & Stat. 638 (1998) (finding that financial intermediaries increase factor productivity).

dustry and prevent it from being reduced merely to managing local monopoly positions.[136]

Building a strong financial center has been an important legislative goal also in Germany, where the government in 1992 went as far as branding its legislative campaign, "Finance Center Germany" (*Finanzplatz Deutchland*).[137] Accordingly, the proposal for one of the recently adopted omnibus laws to modernize corporate law states that its objective is to "strengthen Germany's ability to compete as a financial centre and enhance the function of the capital market as a force promoting growth and employment."[138] Similarly, the website of the recently created state securities agency explains:

> Securities supervision is the youngest discipline within Germany's regulatory framework. It was created as a result of the Second Financial Market Promotion Act, which was adopted on 26 July 1994. This legislation prompted a far-reaching reform of Germany's regulatory system for securities markets. The principal objective was to bolster the efficiency of Germany's financial sector, thus enhancing its ability to compete within the international arena.[139]

The same has been the case in France,[140] and the in United Kingdom, where a 1995 government white paper titled "Competitiveness" concluded that, while London was still "the leading international financial centre in Europe," it would "continue to face competitive pressures from elsewhere," noting in particular "initiatives to promote

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[136] Draghi, *supra* note 36.

[137] *See* Deeg, *supra* note 41, at 180; *see also* Federal Ministry of Finance, Benchmark Paper: The Financial Market Promotion Plan 2006 (March 5, 2003), http://www.bundesfinanzministerium.de/Anlage17775/Benchmark-Paper-The-Financial-Market-Promotion-Plan-2006.pdf; *see also* Hans Eichel, Exchanges and their Customers (Speech of the Federal Minister of Finance at the 8th European Financial Markets Convention in Frankfurt, Jun. 2, 2004), http://www.bundesfinanzministerium.de/nn_13044/EN/News/Speeches/24590.html.

[138] *See* Federal Ministry of Finance, Draft of a Fourth Financial Market Promotion Act (Nov. 14, 2001), http://www.bundesfinanzministerium.de/nn_13044/EN/10420.html. The proposal further explains that to achieve this objective the government intends "to improve investor protection by enhancing market integrity and transparency, to afford market participants extended and more flexible scope for action, and to close gaps in the defences against money laundering." *See id.*

[139] Federal Financial Supervisory Authority, History of Securities Supervision, http://www.bafin.de/cgi-bin/bafin.pl?sprache=1&verz=01_About_us*07_History*03_History_of_Securities_Supervision&nofr=1&site=0&filter=w&ntick=1.

[140] *See* Colin Gordon, The Business Culture in France, *in* Business Cultures in Europe 86 (Collin Randlesome et al. eds., 1990).

the attractions of established rival centres, such as Europlace for Paris and Finanzplatz Deutschland for Frankfurt."[141]

The market for investments is different from the market for incorporations not only in its higher stakes but also in its ability to sustain vigorous participation by multiple jurisdictions. There are two related reasons for this. The first is the difference in stakes. Delaware, the leading state of incorporation in the United States, currently earns about $500 million a year by taxing incorporations. If Delaware were to split this amount with an equal rival, each would collect no more than half. This is not a lot of revenue for a state, and certainly not a lot for a country. By contrast, the stock capitalization of public companies alone in the European Union was $8 trillion in 2003. A conservative estimate of the foreign investments in these companies in that year exceeds $2 trillion.[142] Splitting this amount and the economic development it can generate between several jurisdictions still leaves more than enough to fight over.

Secondly, unlike the market for incorporations, the market for investments is not one in which the winner takes all. Delaware dominates the market for incorporations in the United States. It is the legal domicile of half of the public companies, and virtually all of the companies that incorporate outside their home state when they go public. But it carries this burden in stride. Indeed, judging from the modest outlays for its chartering business,[143] as well as from its efforts to attract additional business to its division of corporations and five-judge Chancery Court, Delaware could easily handle the chartering of all public companies in the United States if only given the chance. The market for capital is different from the market for incorporations because it channels investments into physical businesses. There is a limit to the amount of capital that investor-friendly legislation can attract to a jurisdiction because, as production increases, so does the

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[141] *See* Competitiveness: Forging Ahead (Presented to Parliament by the President of the Board of Trade and the Chancellor of the Exchequer, the Secretaries of State for Transport, Environment and Employment, the Chancellor of the Duchy of Lancaster, and the Secretaries of State for Scotland, Northern Ireland, Education and Wales by Command of Her Majesty, May 1995, Cm 2867), http://www.archive.official-documents.co.uk/document/dti/dti-comp/dti-comp.htm.

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

[143] *See supra* note 110.

cost of local labor and other means of production that are less mobile than capital.[144] This limit gives hope to other jurisdictions that, with proper legislation, they too can attract capital.[145]

B. Costs

Competing for incorporations is costly. It differs from competition in the private sector only in that it involves political costs in addition to economic ones.[146] The costs that stand out in the European Union are the cost of building legal infrastructure and the cost of overcoming resistance from interest groups. The former cost inhibits competition by small member states. The latter inhibits competition by large ones. The combination of the two leaves precious little ground for competition to develop. While these costs do not disappear in competition for investments, they can be offset by the higher stakes involved, which can induce even large jurisdictions with developed legal infrastructure to compete and, can mollify even strong interest groups by forcing them to bear the cost of their resistance.

1. Competition for Incorporations

Impressed by tiny Delaware's successful pursuit of incorporations, some commentators have suggested that the smallest member states in

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[144] *See* Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416 (1956). Previous analyses of corporate lawmaking in federal systems, including my own, have analogized the competition for incorporations to the regulatory competition described by Tiebout. *See, e.g.*, Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908, 1948 n.156 (1998); Roberta Romano, The Future of Hostile Takeovers: Legislation and Public Opinion, 57 U. Cin. L. Rev. 457, 466 n.21 (1988) (same); John C. Coffee, Jr., Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation, 50 Bus. Law. 447, 453 n.27 (1995); Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 691 n.29 (1984). Competition for investments, however, is closer to the Tiebout model because, in both, jurisdictions face increasing costs of providing services to businesses. While in theory jurisdictions should also face increasing costs of providing incorporation services, in practice these costs are small.

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

[146] *See* Kahan & Kamar, *supra* note 1, at 730-35.

the European Union might compete for incorporations on the theory that they alone would value the modest gains to be had.[147] But these member states lack the necessary legal infrastructure to attract incorporations. Consider, for example, Estonia, Latvia, and Malta, the member states with the smallest budgets in the European Union, with total government revenues in 2002 of less than €3 billion each.[148] It is true that these member states might be interested in incorporations. But their interest is not enough.[149] Corporate laws in these member states are antiquated versions of German or French corporate law that have been in hibernation for several decades and only recently received a facelift to meet the minimum requirements of the European Union.[150] These member states also rank low in the European Union in terms of political stability, rule of law, and control of corruption.[151] It is hard to

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[147] *See* Dammann, *supra* note 5, at 528-30 (listing Estonia, Hungary, Cyprus, the Czech Republic, Latvia, Lithuania, Malta, Poland, and Slovakia as potential competitors).

[148] Survey of the State Budget, at 4 (Republic of Latvia Ministry of Finance, Dec. 2002), http://www.fm.gov.lv/image/file/Dec_02a.pdf; Economic Indicators, at 18 (Malta National Statistics Office, 2004), http://www.nso.gov.mt/Indicators/econindic.pdf; General Government Finance Statistics 2002, at Item 1 (Ministry of Finance of the Republic of Estonia, Dec. 31, 2002), http://www.fin.ee/?id=3064.

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

[150] *See* Marie-Agnes Arlt, Cécile Bervoets, Kristoffel Grechenig & Susanne Kalss, The Status of the Law on Stock Companies in Central and Eastern-Europe: Facing the Challenge to Enter the European Union and Implement Company Law, 4 Eur. Bus. Org. L. Rev. 245 (2003) (describing the corporate laws of the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia).

[151] *See* World Bank Institute, Governance Indicators: 1996-2002 — Global Comparative Charts, http://www.worldbank.org/wbi/governance/govdata2002/excelgraphs.html (ranking these member states in the bottom half of the European Union); Transparency International, Corruption Perceptions Index 2004, http://www.transparency.org/cpi/2004/cpi2004.en.html (same). These member states also rank low in the European Union in an indicator of competitiveness that combines economic performance, government efficiency, business efficiency, and *infra*structure. *See* World Competitiveness Yearbook, http://www01.imd.ch/documents/wcy/content/ranking.pdf.

believe that any of them would attract the sort of large public companies that generate the bulk of Delaware's profits.[152]

Recognizing the disadvantages of these member states, some commentators look to Luxembourg, the smallest developed member state in the European Union, to carry the torch of competition.[153] Perhaps. But Luxembourg is not really that small. In 2003, its revenue totaled €6.35 billion, three times higher than Delaware's.[154] Accordingly, the country has done absolutely nothing to signal any intention to compete for incorporations despite much academic speculation that it should.[155] It did not rush to amend its law to allow foreign companies to incorporate in it, nor did it respond to the call for comments on a proposed European Union directive that would enable companies to reincorporate.[156] Although Luxembourg may begin to show interest in incorpo-

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[152] Experience shows that it is large public companies that can generate for a popular incorporation state the bulk of its benefits. Without their active involvement in incorporations, lawmakers have little reason to compete. *See* Marcel Kahan & Ehud Kamar, Price Discrimination in the Market for Corporate Law, 86 Cornell L. Rev. 1205, 1251 t.3 (2001) (reporting that about 1600 large public companies out of more than 200,000 Delaware companies on average generated for the state two-thirds of its franchise tax revenue over the 1997-1999 period).

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

[154] *See* State of Delaware Financial Overview Fiscal Year 2004, http://www.state.de.us/budget/budget/fy2004/operating/04FinancialOverview.pdf (noting a budget of $2.3 billion in 2003). The exchange rate in 2003 ranged between 0.94 and 0.81 euro for one U.S. dollar. Some commentators argue that the relevant figure for a state's incentive to compete for incorporations is its gross domestic product, rather than its budget, because it reflects the extent of economic activity that could be taxed should the need arise in the future, and notes that Luxembourg's gross domestic product is one-half of Delaware's. *See* Dammann, *supra* note 5, at 528. As a practical matter, however, state policymakers tend to consider existing budgetary needs, rather than hypothetical ones, and value any revenue source according to its relative contribution to that budget.

[155] While Luxembourg used to attract some incorporations by protecting investor privacy, international pressure to combat money laundering has narrowed this tax loophole in its law. *See* Telephone Interview with Guido Fauda, Partner, and Giampiero Miccoli, Associate, Janni, Magnocavallo, Fauda, Brescia e associati, Milan, Jul. 28, 2004.

[156] Of 127 responses to the call by the European Commission in 2004 for comments on the proposal, 52 responses came from Germany, 21 from France, 9 from the Netherlands, 7 from Belgium, 6 from Spain, 5 from the United Kingdom, 4 from each of Finland and Portugal, 3 from each of Austria, Greece, and Italy, 2 from each of the Czech Republic and Estonia, 2 from undisclosed countries, and 1 from each of Denmark, Ireland, and Sweden. No responses came from Luxembourg, Cyprus, Hungary, Lithuania, Latvia, Malta, Poland, Slovakia, or Slovenia. *See* Public Consultation on the Outline of the Planned Proposal for a European Parliament and Council Directive on the Cross-Border Transfer of the Registered

rations as the ability to incorporate abroad becomes established in the European Union, there are more reasons to doubt that it will.[157] Corporate law is not Luxembourg's strong point. In fact, along with other corporate laws in the French tradition, the country receives the lowest marks in international comparisons.[158] Few lawyers outside Luxembourg are familiar with Luxembourg corporate law, and many would find the fact that English is not an official language in Luxembourg to be a deterrent.[159] The backbone of its economy is private banking.[160] That Luxembourg will compete for incorporations by the sort of public companies that can generate significant profits is not impossible, but it is unlikely.

This lack of legal infrastructure is particularly problematic because of the need to offer an alternative to incorporation in the United Kingdom. Unlike Luxembourg, or any other member state for that matter, the United Kingdom does not need to revamp its law or build legal infrastructure from scratch to attract incorporations. Its law already offers both flexibility and shareholder protection,[161] and legions of legal and financial professionals both inside and outside its borders are already familiar with it.[162] This track record is important. In the

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Office of a Company, http://europa.eu.int/yourvoice/results/transfer/index_en.htm.

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

[158] *See* Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, Law and Finance, 106 J. Pol. Econ. 1113 (1998).

[159] *See* The Galling Rise of English, Economist, Feb. 27, 2003 (noting that English has become the language of business in the European Union). It is irrelevant that many Luxembourgian speak English because this language is not used in courts.

[160] In 1998, Luxembourg and Switzerland refused to be bound by the Organization for Economic Co-Operation and Development's (OECD) guidelines for combating harmful tax competition because these guidelines called for sharing information about the income of individuals and businesses with foreign tax authorities. *See* Harmful Tax Competition: An Emerging Global Issue, Annex II, at 73 (OECD, Jan. 1, 1998), http://www.oecd.org/dataoecd/33/0/1904176.pdf. Luxembourg maintains its refusal to exchange this information today. *See* The OECD's Project on Harmful Tax Practices: The 2004 Progress Report, at 10 (OECD, Mar. 22, 2004), http://www.oecd.org/dataoecd/60/33/30901115.pdf.

[161] British corporate law does contain a duty to consider employee interests. *See* Company Act of 1980, § 309. However, in reality, this duty is used by management to justify actions not favored by shareholders, rather than being used by employees to claim protection of their interest. *See* Company Law Review Steering Group, Modern Company Law for a Competitive Economy — The Strategic Framework, at 41, ¶ 4.1.21 (Feb. 1999), http://www.dti.gov.uk/cld/comlawfw/framewrk.pdf.

[162] Unlike most other member states, the United Kingdom already allows local businesses to incorporate abroad. That virtually none of them ever incorporates in other

early twentieth century, when New Jersey drove away its chartered companies with tough antitrust laws, incorporators looked no further than Delaware because it already had the law they wanted. The United Kingdom appears to be the instinctive choice for them in the European Union for similar reasons.[163]

The United Kingdom, however, is not competing for incorporations and is not likely to do so in the future.[164] It is too big to care about the modest incorporation fees it can hope to collect, and, in fact, it does not even bother to charge such fees.[165] Its corporate law is liberal because of its common law tradition, not because of any government plan to attract incorporations. Indeed, what some regard as the centerpiece of British corporate law, The City Code on Takeovers and Mergers, applies only to companies headquartered in the United Kingdom,[166] and was introduced in the 1960s — long before incorporations abroad were thought possible in the European Union — in response to a public uproar against abuses in the domestic takeover market.[167] Similarly, the corporate governance requirements of the state-sponsored listing rules apply only to companies that use the

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member states or, for that matter, in the United States, suggests that the British law appeals to their managers and shareholders more than the alternatives.

163 *See* David F. Hickok & Thomas Schürrle, The "Inspire Art" Judgment of the European Court of Justice: New Ways to Structure Acquisitions in the European Union?, Debevoise & Plimpton Memorandum to Clients (Jan. 20, 2004), http://www.debevoise.com/publications/pubsdetail.asp?pubid=1011201232004&typeid=4#; *Inspire Art:* New Opportunities for Corporate and Private Equity Structuring, Latham & Watkins Corporate Department Client Alert No. 372 (Feb. 26, 2004), http://www.lw.com/resource/Publications/_pdf/pub931_1.pdf; Herald Halbhuber, National Doctrinal Structures and European Company Law, 38 Common Mkt. L. Rev. 1385, 1403 (2001) ("England is widely perceived as the most likely candidate for a European Delaware"); *see also* UK Governance Is the Best in Europe, Accountancy, Apr. 3, 2004, at 113 (citing a report by Brussels research firm Deminor's conclusion that "Britain has Europe's best corporate governance while Germany, Spain and the Netherlands have among the worst").

164 Some commentators argue that the legal and accountancy professions in the United Kingdom have both the desire and power to cause the United Kingdom to compete for incorporations. *See supra* note 92 and accompanying text. I understand the motivation behind the British proactiveness differently.

165 *See* Cheffins, *supra* note 5, at 435.

166 *See* City Code on Takeovers and Mergers, Introduction, http://www. thetakeover-panel.org.uk.

167 *See* Stephen Kenyon-Slade, Mergers and Takeovers in the US and UK Law and Practice 506-07 (2004) (noting that the impetus for establishing the code and the panel enforcing was widespread criticism of the issuance of large block of shares by Metal Industries to white squire Thorn Electrical to ward off an attempted takeover by Aberdare Holdings' in 1967).

London Stock Exchange for primary listing.[168] These important parts of the law were designed with local businesses in mind, and given the difficulty of forcing foreign businesses to comply, the law will probably continue to apply only locally in the future.[169]

The costs of building legal infrastructure are only part of the burden involved in competing for incorporations. Other barriers result from the need to overcome political opposition. Lawmakers will not spend political capital to attract incorporations just because doing so might benefit the state. They will first consider the effects of such an effort on their careers, taking into account the magnitude of the benefits to the state, the time and likelihood involved in achieving results, the ability to claim personal credit for success, the repercussions of failing, the availability of alternative legislative projects, and the likely opposition.[170]

It is beyond the scope of this Article to catalogue all the political costs that could stand in the way of competition for incorporations. Suffice it to say that these costs can be substantial because an intricate web of interest group politics shapes corporate law in many member states, especially ones possessing the necessary legal infrastructure to attract incorporations. Developed member states tend to carry significant political baggage that can be crippling in a market for incorporations. One such political hurdle is strong labor. If there is one matter on which managers and shareholders agree it is about limiting employee influence over corporate strategy.[171] Yet this is also among the

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[168] *See* United Kingdom Listing Authority, The Listing Rules, ¶¶ 17.12, 11.14, http://www.fsa.gov.uk/pubs/ukla/chapt17-3.pdf. Of 133 foreign European Union firms listed on the London Stock Exchange on July 30, 2004, only 15 firms out had their primary listing there. Of these, 11 firms were Irish, 1 was German, 1 was Danish, and 2 were Italian. The total number of Irish companies listed on the London Stock Exchange was 58. *See* London Stock Exchange, List of Companies, http://www.londonstockexchange.com/en-gb/pricesnews/statistics/listcompanies.

[169] Corporate lawyers bemoan the refusal of the British City Panel on Takeovers to apply the City Code on Takeovers and Mergers to companies incorporated and listed in the United Kingdom but operating abroad. *See* Freshfields, *supra* note 13, at 17 (noting that these so-called "orphan" companies currently "have to include certain takeover precautions in their articles of association to reassure investors").

[170] *See* Kahan & Kamar, *supra* note 1, at 727-35; *cf.* R. Douglas Arnold, The Logic of Congressional Action 68-71 (1990).

[171] *See* Marco Pagano & Paolo Volpin, The Political Economy of Corporate Governance, 95 Am. Econ. Rev. 1005 (2005) (finding that employee protection tends to be stronger, and shareholder protection tends to be weaker, in proportional, as opposed to majoritarian, electoral systems); Mark J. Roe, Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539 (2000) (arguing and presenting

most sensitive political issues in these member states. A related hurdle is protectionism. Efficient corporate law is one that allocates corporate assets to their best use. Yet it requires neutrality that politicians tend to lack when it implies the transfer of local businesses to foreign hands.[172] This protectionist impulse has so far stymied efforts in the most developed member states to pass legislation that might expose domestic manufacturers to foreign acquisitions.[173]

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evidence that social democracies tend to have weaker shareholder protection).

[172] The desire to protect local industry has many a time driven elected officials in developed member states of the European Union to weigh in when major domestic manufacturers were about to be sold to foreign buyers. *See, e.g.*, Andrew Bulkeley & Ross Tieman, Fighting the Inevitable in France, Corp. Control Alert, Jun. 2004, at 20 (describing the intervention by the French government to stir French pharmaceutical Aventis away from Swiss acquirer Novartis and into the hands of its domestic rival Sanofi-Synthelabo in 2004); Patrick Jenkins, Ackermann's Agenda: Deutsche Bank Grapples With Divisions Over Strategy, Fin. Times, Sept. 16, 2004, at 19 (describing the lobbying by German powerhouses Siemens, Deutsche Telekom, and SAP to prevent foreigners from buying Deutsche Bank); Paul Betts & Victor Mallet, A French Solution, Fin. Times, Jul. 3, 2002, at P18 (describing the political opposition that blocked the acquisition of French oil company Elf Aquitaine by Italian group Eni in 1999 and the acquisition of Belgian company Société Générale de Belgique by Italian financier Carlo De Benedetti in 1988). European governments have been particularly persistent in using so-called golden shares to block the acquisition of privatized companies by foreign buyers. *See* Carlta Vitzthum, Madrid Exercises Its 'Golden Shares' on Foreign Deals, Wall St. J., May 18, 2000, at A23 (describing the government blocking of an acquisition of the Spanish company Telefonica by Dutch company KPN, an acquisition of the Spanish company Hidroelectrica del Cantabrico by Electricité de France, and an acquisition of Telecom Italia by Deutsche Telekom). In 2003, the European Court of Justice declared this practice illegal. *See* James Kanter, EU's Top Court Further Curbs Use of Golden Shares, Wall St. J., May 14, 2003, at A12. But the motivation to avert acquisitions of major local companies by foreign buyers persists. *See* Christopher Emsden & Jonathan House, BNL Board Calls BBVA Bid 'Fair,' Nearing Deal, Wall St. J., Apr. 11, 2005, at M3 (describing Bank of Italy's aversion to the acquisition of Italian banks by foreign acquirers); Daniel Dombey & Hugh Williamson, Germany Tells Brussels It Will Not Alter VW Law, Fin. Times, Jul. 13, 2004, at 11 (describing a showdown between Germany and the European Commission over a law specifically designed to protect carmaker Volkswagen from foreign acquisitions).

[173] *See* Freshfields Brukhaus Deringer, The Takeover Directive (May 2004), http://www.freshfields.com/practice/corporate/publications/pdfs/TakeoverDirective_May r04.pdf (explaining that what ended the 14-year debate over the takeover directive was a comprise allowing member states to permit antitakeover defenses); John W. Cioffi, Restructuring 'Germany, Inc.': The Corporate Governance Debate and the Politics of Company Law Reform, 24 L. & Pol. 355 (2002) (describing opposition in Italy to legislation that would expose Italian firms to takeovers by British and Dutch firms); Scott V. Simpson, The Effect of the 13th Directive on US Bidders, in The International Financial Law Review Guide to Mergers and Acquisitions 2004, http://www.legalmediagroup.com/IFLR/ includes/print.asp?SID=5275 (explaining that the permission granted in the takeover directive to member states banning antitakeover defenses to exempt defenses against

All of these political hurdles can easily retard legislation that would attract incorporations at the expense of local workers. This hindrance can be significant. Laws mandating labor representation on the board of directors or requiring consultation with employees in mergers are hardly the way to go if member states are to attract incorporations, because neither managers nor shareholders gain from these requirements. And while commentators still disagree on the effect of antitakeover laws on incorporations,[174] they agree that American states that adopted them in the past were motivated solely by a desire to shelter local businesses from foreign acquisitions and did not consider their effect on incorporations.[175] If these states were to follow Delaware, whose law is driven solely by the pursuit of incorporations, they would have adopted much milder antitakeover statutes, if any at all.[176]

2. Competition for Investments

It is hard to compare the costs of harnessing corporate law for the purpose of competing for investments to the costs of harnessing corporate law in order to compete for incorporations. Some of the

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bidders not subject to a similar ban protects European firms from takeovers by American firms).

[174] *Compare* Lucian Bebchuk, Alma Cohen & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law, 90 Cal. L. Rev. 1775 (2002) (arguing that corporate decisionmakers favor states with antitakeover statutes), *and* Subramanian, *supra* note 108 (same), *with* Marcel Kahan, The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?, J.L. Econ. & Org. (forthcoming 2006) (finding no evidence that antitakeover laws affect incorporation decisions), *and* Daines, *supra* note 109 (same).

[175] *See* Henry N. Butler, Corporate-Specific Antitakeover Statutes and the Market for Corporate Charters, 1988 Wis. L. Rev. 365 (describing state antitakeover statutes as an effort to shelter local businesses from takeovers); William J. Carney, The Production of Corporate Law, 71 S. Cal. L. Rev. 715, 750-51 (1998) (same); Romano, *supra* note 144, at 461 n.11 (same).

[176] Some commentators argue that Delaware makes up with a liberal judicial approach towards poison pills for what it misses in antitakeover legislation. *See* Bebchuk, Cohen & Ferrell, *supra* note 174, at 1803-04. However, Delaware adopted its mild antitakeover statute in early 1988. *See* An Act to Amend Chapter 1, Title 8, Delaware Code Relating to the General Corporation Law, 66 Del. Laws, c. 204, § 1 (Feb. 2, 1988). The Delaware Chancery Court at that time did not allow the use of poison pills against takeover bids deemed inadequate by the board of directors. *See* AC Acquisitions Corp. v. Andreson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986). This judicial approach persisted after the enactment of the antitakeover statute. *See* Grand Metropolitan, PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988); City Capital Associates v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988). It was not until 1989 that the Delaware Supreme Court replaced this approach with greater deference to the board of directors. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152-53 (Del. 1989).

costs are higher in the case of the former type of competition, other costs are higher in the latter, and still other costs are the same. This Section therefore does not argue that competition for investments will always be present where competition for incorporations is not, only that it can be. In the European Union, this is already the case.

Consider first the cost of building legal infrastructure. This cost is the same whether member states compete for investments or for incorporations. In either case, only member states that provide quality legislation, adjudication, and legal services can compete. But in the case of competition for investments, the member states that possess the necessary legal infrastructure, which tend to be the larger and more developed ones, are not precluded from competing. The member states that have been the most active in the wave of corporate law reforms of recent years are not the smallest in the European Union. Indeed, they may well be the largest. Whether or not large states use corporate law to lure investments more than others, size is evidently not an impediment.

Member states with underdeveloped legal infrastructure would find the pursuit of incorporations particularly challenging because they would need to match the solid legal infrastructure of the United Kingdom. It does not matter that the United Kingdom is not competing for incorporations. Any member state wishing to attract incorporations must still offer a viable alternative. Competition for investments is different. Such competition does not lend itself to just one winning jurisdiction since the product for sale is a package that contains more than corporate law. Even if all corporate decisionmakers agree that the combination of legal infrastructure and substantive corporate law in the United Kingdom is superior to that in any other member states, not all firms will choose the United Kingdom as their home, and not all capital investments will flow into the United Kingdom. Both businesses and investments will be spread among member states in accordance with the distribution of the means of production, both physical and legal. It should be entirely possible for a member state offering, for example, cheap labor, low taxes, or rich natural resources, to use corporate law to stimulate economic development even if its legal infrastructure falls short of the United Kingdom's.

In contrast, consider the political costs of overcoming opposition to corporate law reform. Some of these costs are seen in both the competition for investments and the competition for incorporations because they stem from opposition by interest groups that are not directly affected by production activity. In the 1990s, for example, Nevada abandoned a plan that would have designated certain judges to hear

only business disputes because the change would have required a protracted constitutional amendment and would have reopened an earlier debate about designating judges to hear only family disputes.[177] Around the same time, Pennsylvania scrapped an initiative to form a juryless business court partly due to opposition from public interest lawyers who were concerned that low income individuals might find themselves in that court.[178] Because the opposition in both instances did not come from corporate constituencies, it would have likely been the same regardless of whether the reform had affected mostly local firms (as in competition for investments), or firms operating in other states (as in competition for incorporations).

But opposition to corporate law reform can also come from corporate constituencies, such as employees, consumers, or residents in areas where production takes place. These groups show greater resistance to corporate law reform when it affects local firms. The failed Pennsylvania chancery court initiative serves again as a useful example because it was opposed not only by the public interest bar but also by labor unions.[179] These unions presumably would have been less resistant to the reform had the initiative affected mostly corporations operating in other states. They cared about the reform and had the clout to block it because it would have affected a great number of local employees. By contrast, consider the restraint that Delaware has shown in not adopting strong antitakeover statutes despite their popularity with labor unions. Few local employees were affected by that policy because most Delaware firms are based in other states.[180]

Since competition for investments affects mainly local businesses, it will normally encounter stronger opposition than competition for incorporations. But this opposition can be muted if competitive pressures in the markets for products, capital, and labor compel local corporate constituencies to internalize the cost of inefficient corporate law and accept reform. This is forcefully illustrated by the recent push in Germany to relax the so-called codetermination right entitling

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[177] *See* Minutes of the Nev. Legis. Commission's Subcomm. To Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State, 1999 Leg., 1999-2000 Interim Sess. (May 30, 2000) (testimony of A. William Maupin, Associate Justice, Supreme Court of Nevada), available at http://www.leg.state.nv.us.

[178] *See* Mark A. Tarasiewicz, Chancery Ct. Opposed by Bar Ass'n, Resolution Is Withdrawn, Legal Intelligencer, Jun. 1, 1992, at 1.

[179] *See* John L. Kennedy, Chancery Ct. Plan Sent to Senate, Legal Intelligencer, May 17, 1993, at 1.

[180] *See* Romano, *supra* note 116, at 57-60.

employee representatives to half the supervisory board seats in large companies.[181] Such a reform was unthinkable only a decade ago. Today it is endorsed by employer organizations, large banks, and state officials as essential to preventing business from fleeing Germany in an increasingly integrated and competitive economic environment.[182] Thus, a recent report by the two largest employer organizations in Germany complains that codetermination inhibits the growth of German companies by making them unattractive merger partners abroad.[183] Similarly, according to the chair of the German government's standing committee on corporate governance, who also chairs the supervisory board of ThyssenKrupp, the country's fifth-largest industrial company, "other countries do not regard German codetermination practices in their current form as a plus point for Germany as a business location.[184] Reforming codetermination would no doubt

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[181] *See* Matthew Karnitschnig, German Board Law Targeted, Wall. St. J., Oct. 28, 2004, at A13 (reporting a "declaration of war" by the German Industry Association and the German Employers Association on a "pillar of the German workers' movement that has defined labor relations for a generation" — the rights of employees to half the seats on supervisory boards of big corporations — "as companies increasingly shift factories and jobs from Germany to cheaper, less regulated markets"); Gail Edmondson, Cut Labor's Clout on German Boards, Bus. Wk, Nov. 15, 2004, at 84 (noting that relaxing the decades old codetermination rules "could be a secret bullet against outsourcing and high unemployment"); David Gow, Chill Enters Cosy German Boardrooms, Guardian, Oct. 25, 2004, at 22 (citing the president of Kiel Institute for World Economics opining that Germany's codetermination "must be adapted to meet modern demands for entrepreneurial flexibility, especially among foreign investors" and noting that "the most telling business argument for change is that co-determination is an obstacle to cross-border mergers or, as in the case of Hoechst and Rhone-Poulenc (now Aventis), forces the transfer of the company headquarters outside Germany").

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

[183] For the claim by Germany's largest employer organizations that labor representation on the board deters foreign investors and makes German companies unattractive merger partners, see *Bundesvereinigung der Deutschen Arbeitgeberverbände & Bundesverband der Deutschen Industrie, Mitbestimmung Modernisieren* [Union of the German Employers' Associations & Association of the German Industry, Modernizing Codetermination] 7-8, 19 (2004), http://www.bdi-online.de/dokumente/berichtbdabdikommission modernisierungmitbestimmung.pdf. For a similar claim by a leading German commentator, see Marcus Lutter, *Perspektiven des Gesellschaftsrechts in Deutschland und Europa* [Perspectives on Corporate Laws in Germany and Europe], 59 Betriebs Berater I (2004).

[184] *See* Gerhard Cromme, The Status and Development of Corporate Governance in Germany 17, *in* 3rd German Corporate Governance Code Conference on June 24, 2004 in

adversely affect German employees. But losing jobs to employees abroad is worse."[185]

III. NORMATIVE IMPLICATIONS

Standard accounts of corporate lawmaking in federal systems explain both the rate at which jurisdictions innovate and the degree to which these innovations accommodate corporate decisionmakers as a product of competition for incorporations.[186] This does not mean, however, that the law must stagnate when this type of competition is absent. Competition for investments has powerful and quite different effects of its own. Such competition can readily spread over many jurisdictions, including large and developed ones, without any one jurisdiction dominating the market. And it affects companies based on their physical location rather than their choice of legal domicile. This explains why corporate legal reforms marshaling shareholder rights have been spreading in the European Union notwithstanding the absence of freedom to incorporate abroad and, as will be explained further below, why introducing such freedom may undermine this trend. The choice to incorporate abroad may thus be a mixed blessing. On the one hand, it frees firms from having to wait for their home jurisdiction to bring the quality of local corporate law up to the level available elsewhere. On the other hand, to the extent that the freedom to incorporate abroad weakens the pressure on jurisdictions with inferior corporate law to improve, it also deprives firms locked in these jurisdictions of the improvements that more intense competition for investments would generate.

Berlin, http://www.corporate-governance-code.com/eng/download/CGC_Conference_Berlin_2004_Dr_Cromme.pdf.

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

[186] The definitive work in this area is Romano, *supra* note 2. For updated empirical findings, see Roberta Romano, The States as a Laboratory: State Competition for Corporate Charters, *in* Promoting the General Welfare: American Democracy and the Political Economy of Government Performance (Alan S. Gerber & Eric M. Patashnik eds., forthcoming 2005); *see also* Carney, *supra* note 175.

A. *Competition for Investments and Competition for Incorporations Compared*

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

1. *Who Competes and How*

Perhaps the most apparent distinction between competition for investments and competition for incorporations is in the type and the number of jurisdictions likely to compete.

Competition for incorporations naturally involves only a handful of small jurisdictions, or a single small jurisdiction, because the benefits from attracting incorporations are modest and because firms gravitate towards the jurisdiction with the largest number of incorporations. In the United States, that jurisdiction is Delaware, a state that ranks 45th in population and 38th in gross product.[187] A similar pattern in the European Union would mean a clustering of incorporations in a single small member state and a lack of attention by larger member states to incorporations.

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

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[187] *See* U.S. Census Bureau, State Rankings — Statistical Abstract of the United States: Resident Population — July 1, 2004, http://www.census.gov/statab/ranks/rank01.html; U.S. Census Bureau, State Rankings — Statistical Abstract of the United States: Gross State Product in Current Dollars, 2003, http://www.census.gov/statab/ranks/rank28.html.

member states. It is beyond the scope of this Article to empirically test whether large and developed jurisdictions use corporate law to compete for investments more than other jurisdictions. Such a finding would certainly be consistent with the major corporate law reforms in such member states as Germany, Italy, and France in recent years. It could be explained by the pressure for reform that developed industries can put on lawmakers, as well as by the likelihood that a developed jurisdiction will posses the necessary legal infrastructure to compete.[188] But it is not necessary to resolve this question here. Regardless of whether large and developed jurisdictions use corporate law to compete for investments more than other jurisdictions, they certainly do not appear to fall behind.

While competition for investments and competition for incorporations attract different sets of jurisdictions, the incentives they create are similar. In both cases, competing jurisdictions produce the law most likely to win the approval of both the managers who must initiate corporate decisions and the shareholders who must consent to them. In the European Union, competition for investments has thus far resulted in a trend towards shareholder protection, a reassuring sign for the view that regulatory competition yields a race to the top.[189] Thus, between 1993 and 2002 alone, before several important reforms took place, a widely-used country score for shareholder protection either increased or remained unchanged in each of fourteen European member states surveyed in a study of corporate laws around the world.[190]

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[188] Other determinants that may affect the propensity to compete for investments through corporate law reform include government budget deficit, privatizations, exposure of local industry to foreign competition, and demand by local industry for additional capital.

[189] *See* Pagano & Volpin, *supra* note 171 (finding that over the 1990s shareholder protection improved on average in 45 countries despite the absence of changes in electoral systems or legal origin, and concluding that in that decade there was international convergence in shareholder protection); Accountancy, *supra* note 163 (citing a report by Brussels research firm Deminor's conclusion that corporate governance standards are improving in Continental Europe's as a whole).

[190] The shareholder protection score is the so-called "antidirector rights" indicator constructed in La Porta, Lopez-de-Silanes, Shleifer & Vishny, *supra* note 158. It is tracked for every year from 1993 to 2002 in Pagano & Volpin, *supra* note 171. The member states in the study are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, and United Kingdom. The unweighted average increase for the 14 member states was 24%, compared to an unweighted average increase of 10% for the other 33 countries in the study. The increase was the highest for Italy, which received a score of 1 in 1990 and 5 in 2002, consistent with the fact that Italian government

More specifically, however, the trend has been towards adopting rules and practices similar to those in the United Kingdom and the United States.[191] The use of Anglo-American corporate law as a reference point is noteworthy. While there are many ways to protect shareholders, the Anglo-American way is a particularly effective one because British and American investors have been the ones to spread shareholder activism globally,[192] and because, with the advent of international law firms, investment banks, and accounting firms, the legal template these investors endorse has become the gold standard in shareholder protection worldwide.[193]

The power of Anglo-American investors to set the tone for the market is substantial. In 2002, for example, when California Public

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officials had publicly cited that score as a benchmark for Italy's corporate reform. *See* Ulissi, *supra* note 77.

[191] While British corporate law and American corporate law are similar, important differences between them do exist. An example of a British rule with no American equivalent that has spread across the European Union is the rule mandating a buyer of a substantial equity stake in a company to offer to buy the remaining shares on the same terms. For the British rule, see Kenyon-Slade, *supra* note 167, at 676. For its adoption in other member states between 1990 and 2004, see Marc Goergen, Marina Martynova & Luc Renneboog, Coprorate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe, 21 Oxford Rev. Econ. Pol. 243 (2005).

[192] *See* Simon Targett, Custodians Are Casting Votes as They Take On a More Active Role, Fin. Times, Jul. 6, 2001. Continental European investors have gradually adopted Anglo-American shareholder activism and expectations themselves. *See* Sylvia Pfeifer, Shell Investors Demand Royal Dutch Meeting, Sunday Telegraph, Mar. 28, 2004, at 2 (reporting that institutional investors from the United States, the United Kingdom, Holland, and Germany are requesting a meeting with the chairman of Royal Dutch to discuss accounting irregularities); Evans, *supra* note 129, (reporting shareholder activism to improve voting rights and broader governance by ABP and PGGM in the Netherlands, Caisse des Dépôts et Consignations in France, and DWS, Union, and SEB in Germany), Paula Garrido, Shareholders Want Their Voices Heard, Fin. Times Mandate, Mar. 8, 2004 (describing the European Corporate Governance Service, an umbrella organization that comprises eight regional corporate governance organizations representing France, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the Nordic Region); Sara Calian, Making Union Investment's List Isn't Pleasing to European Firms, Wall St. J., Feb. 15, 2002, at C10 (reporting the German pension fund Union's use of public shaming to pressure underperforming companies).

[193] *See* Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757, 841-47 (1995) (arguing that the value of a corporate legal system increases in the number of its users). For standardization in the contracts governing investments other than in stock, see Stephen Choi & Mitu Gulati, Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds, 53 Emory L.J. (forthcoming 2005) (sovereign bonds); Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (Or 'The Economics of Boilerplate'), 83 Va L. Rev. 713 (1997) (corporate bonds).

Employees' Retirement System (CalPERS) announced its intention to liquidate its public stock holdings in four Asian countries citing, among other factors, inadequate market regulation, the main stock indexes in three of these countries dropped between one and four percent. It did not matter that the investments CalPERS planned to liquidate were relatively small. What caused the dramatic drop was a concern among fund managers and analysts that other foreign investors would follow suit.[194] Two months later, CalPERS reversed its decision with respect to one of the countries, the Philippines, after admitting that it had mistakenly identified that country as having a manual stock-trading system. The Philippine stock exchange index then bounced back, pulling with it the Philippine peso.[195] Anglo-American investors are influential in Europe too. As a 1999 newspaper article notes, "while the French were remembering the fall of the Bastille on July 14, President Jacque Chirac recalled the fall of Alcatel" a year earlier, when American investors sent the market value of the French company down 55 percent, or $11.5 billion, in one day following a disappointing earnings report.[196] The Alcatel incident led the French president to call for the creation of an American-style pension system that would free French companies of their dependence on American investors.[197] Needless to say, French pension funds should exhibit an appetite for returns just like their counterparts over the Atlantic.

2. *Firms Whose Costs of Incorporating Abroad Are Low*

Thus far we have identified two key differences between the existing competition for investments and the potential competition for incorporations among member states of the European Union. First, the competition for investments involves large industrialized jurisdictions across the continent rather than a single or a few small jurisdictions. Second, the beneficiaries of this competition are local corporations in competing jurisdictions rather than foreign corporations that

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[194] *See* Karmin & Scannell, *supra* note 145 (reporting a widespread belief among investors that the fallout may at least temporarily slow down a stock price rally driven by high returns).

[195] *See* Jason Booth, Calpers Plan Aides Philippines Stocks, Wall St. J., May 3, 2002, at C11; *see also* Karmin & Hookway, *supra* note 129 (reporting that the Philippine financial secretary met with CalPERS to lobby against its move and praised the fund for its reversal).

[196] *See* Steinmetz & Sesit, *supra* note 127.

[197] *See id.*

incorporate in these jurisdictions. It is now a simple matter to describe the effects of the two types of competition on social welfare.

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

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

3. Firms Whose Costs of Incorporating Abroad Are High

Not all firms would rush to incorporate abroad even if they were free to do so. Many small companies — mostly private, but also public — would consider the cost of incorporating abroad to be too high, especially if doing so entails changing lawyers. In the United States, where there are no language or cultural barriers to incorporating in Delaware while conducting business in another state, and where legal advice on Delaware law is readily available nationwide, the vast majority of private companies incorporate in their home state. In 1999, for example, Delaware was the legal domicile of only 230,000 companies out of roughly 5 million companies in existence nationwide.[198] Even

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[198] *Compare* Kahan & Kamar, *supra* note 152, at 1251 t.3 (reporting that 229,249

public companies do not necessarily incorporate in Delaware. Only half of them do so, typically the larger ones.[199] Many companies in the European Union would find themselves in a similar position if they could choose where to incorporate. It is hard to tell whether their attachment to their home jurisdictions would be higher or lower than that of companies in the United States because the greater diversity of corporate laws in the European Union compared to the United States would raise both the costs and the benefits of incorporating abroad. But the nature of the barriers to incorporating abroad should be similar in both cases.

Companies whose employees, creditors, or managers would oppose a move would also find incorporation abroad costly.[200] Shareholders and managers would probably support incorporation in a member state with minimal employee or creditor protection.[201] But while their agreement would be enough for incorporating new companies,[202] existing companies would need to negotiate with employees and creditors with vested rights.[203] Moreover, managers themselves could

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companies paid franchise tax in Delaware in 1999), *with* United States Census Bureau, Statistical Abstract of the United States 2002, at 471, http://www.census.gov/prod/2003pubs/02statab/business.pdf (reporting that 4,936,000 companies filed tax returns in the United States in 1999).

[199] *See* Robert Daines, Does Delaware Law Create Value?, 62 J. Fin. Econ. 525 (2001) (noting that public companies that incorporate in Delaware tend to have higher total assets than companies that incorporate in other states).

[200] *See* Bebchuk & Roe, *supra* note 9, at 143-47 (arguing that entrenched participants in firms may block even efficient structural changes if these changes would harm them). Note that not all companies will be deadlocked by such divergence of preferences because they buy the consent of the participant blocking the reincorporation. There will probably be firms, however, for which the cost will be too high. How many firms will fall under this category only time will tell. *Compare* Bebchuk & Roe, *id.* at 147-48 (suggesting that many efficient changes can be expected to be blocked), *with* Hansmann & Kraakman, *supra* note 10, at 460-62 (suggesting that few efficient changes can be expected to be blocked).

[201] *See* Debevoise & Plimpton, *supra* note 163; Latham & Watkins, *supra* note 163.

[202] Much like the protagonists of the famous European Court of Justice decisions requiring member states to recognize foreign incorporations — Centros, Überseering, and Inspire Art — the only companies attempting to incorporate outside their home member state thus far have been startup companies aiming to avoid minimum capital requirements. *See* von Falkenhausen Interview, *supra* note 105; Telephone Interview with Rudolf H. Haas, Partner, Latham & Watkins, Frankfurt, Jun. 29, 2004.

[203] Both existing and proposed European Union legislation protect vested rights of creditors and employees of companies that merge with foreign companies or reincorporate abroad. *See* Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European Company (SE), §§ 1, 8(7), 24(1), 34, O.J. L. 294/1; Council Directive Supplementing the Statute on the European Company with Regard to the Involvement of Employees, § 7, O.J. L. 294/22; Proposal for a Directive of the European Parliament and of the Council on Cross-Border Mergers of Companies with Share Capital, §§ 2, 14, COM 2003/703,

be reluctant to reincorporate if they believed the foreign law overly limited their discretion.[204] They would not even need to sue to block the reincorporation; they would simply not initiate it.[205]

These immobile firms would benefit from the competition for incorporations only if they happen to be located in member states that would compete for incorporations more than they compete today for investments. But since, unlike competition for investments, competition for incorporations would likely involve mainly small jurisdictions, few firms fall under this category.[206] Other immobile firms would fare worse than they do now because mobile firms in their member states would incorporate abroad, leaving behind them smaller networks of domestic incorporations and legislatures with fewer reasons to maintain the quality of local corporate law.

While it is easy to identify the advantages and disadvantages of the current competition for investments in the European Union compared to competition for incorporations — the gain to immobile firms from the wider spread of competition, and the loss to mobile firms from the ban on incorporation abroad — it is difficult to assess which effect dominates. On the one hand, there are probably many more immobile firms than mobile firms. That only a fraction of American firms incorporate in Delaware while operating in other states suggests as much. On the other hand, immobile firms tend to need corporate law

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http://europa.eu.int/eur-lex/en/com/pdf/ 2003/com2003_0703en01.pdf; Company Law: Commission Consults on the Cross Border Transfer of Companies' Registered Offices, IP/04/270, http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/270&format=HTML&aged=0&language=EN&guiLanguage=en.

[204] The Sarbanes-Oxley Act of 2002, which has been criticized in the United States on precisely these grounds (*see, e.g.*, Romano, *supra* note 82), is commonly viewed as the main reason for the decline in the popularity of American stock listing among foreign issuers. *See* Bob Sherwood, Long Arm of the US Regulator, Fin. Times, Mar. 10, 2005, at 14; Silvia Ascarelli, Citing Sarbanes, Foreign Companies Flee U.S. Exchanges, Wall St. J., Sept. 20, 2004, at C1; Shanny Basar, Corporates Reduce Foreign Listings, Fin. News, Feb. 2, 2003; Craig Karmin & Kate Kelly, For Stock Listings, the U.S. Pull Gets Weaker, Wall St. J., Nov. 12, 2002, at C1; Andrew Parker & Tony Tassell, Rank Could Look at US Delisting, Fin. Times, Dec. 1, 2004, at 19.

[205] This should be contrasted with the ease with which New Jersey and its successor Delaware attracted reincorporations by promising minimal antitrust regulation. *See* Joel Seligman, A Brief History of Delaware's General Corporate Law of 1899, 1 Del. J. Corp. L. 249, 270 (1976). There is little doubt that, in the absence effective federal antitrust enforcement, reincorporation into New Jersey or Delaware could have significantly harmed consumers. Only consumers could not stop it.

[206] *See* U.S. Bureau of Census, Statistical Abstract of the United States, 2004-2005, at 21, http://www.census.gov/prod/2004pubs/04statab/pop.pdf (ranking Delaware as sixth smallest jurisdiction in population), 213 (ranking Delaware as third smallest jurisdiction in area), 428 (ranking Delaware as the ninth smallest jurisdiction in gross state product),

less than mobile firms, and indeed low willingness to pay for corporate law can account for their immobility. This explains why Delaware attracts less than five percent of incorporations by private firms but roughly half of incorporations by public firms, and why it charges the latter much higher taxes.[207] The inability to determine, based on the foregoing analysis, which type of competition is socially more desirable, however, leaves open a more practical comparison between the current competition for investments, in which firms cannot incorporate abroad, and the regulatory dynamics that will develop once this freedom is introduced. The insights acquired above will inform this inquiry. We shall turn to it next.

B. The Effects of Firm Choice on the Competition for Investments

Comparing the social welfare implications of the current competition for investments in the European Union with those of competition for incorporations is only the first step towards informing the debate about the desirability of firm choice in the European Union or, indeed, anywhere else. To be sure, with the European Court of Justice expressing growing impatience with member states that do not recognize foreign corporations, and with the European Commission appearing poised to pass a directive that would lift existing barriers to cross-border mergers, the freedom to pick any member state as a place to incorporate seems to be just around the corner for European Union companies. But allowing firms to incorporate abroad will not necessarily replace the current competition for investments with competition for incorporations. It may just as well weaken the competition for investments without introducing any new competition for incorporations or, if it does introduce such competition, it may result in the coexistence of the two types of competition. This Section outlines the social welfare implications of each of these scenarios.

1. The Incentives to Compete

While the ability to incorporate abroad may or may not accelerate the development of national corporate laws or make them more favorable to shareholders by fostering competition for incorporations, it may lead to the opposite result by discouraging member states from using their corporate laws to compete for investments. Member states will have fewer reasons to worry about the quality of their corporate

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[207] *See* Kahan & Kamar, *supra* note 152.

law once firms become free to choose where to incorporate because local corporate law will matter less than it does now to their prosperity. This appears to be the case in the United States. New York corporate law, for example, imposes personal liability on the ten largest shareholders of a company for unpaid salaries and wages.[208] Investors consider this rule highly unattractive.[209] But this does not prevent New York from being one of the most prosperous states and home to numerous companies; many of these companies simply incorporate in Delaware instead of New York.

Thus, while the freedom to choose where to incorporate will make the regulatory dynamics in the European Union more like those in the United States, ironically this may weaken, rather than strengthen, the incentives member states have to develop their corporate laws. The reason is that these member states will be left with fewer local firms incorporated domestically, and these firms will tend to depend on the law less than the firms that reveal their dependence by incorporating abroad.[210] Unless the firms that incorporate domestically need a different kind of corporate law from that needed by firms incorporating abroad — which will often not be the case[211] — their needs will

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[208] *See* N.Y. Bus. Corp. Law, § 630 (McKinney 2003).

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

[210] In theory, even the competitive drive of the United Kingdom, which will likely experience an inflow of incorporations, may dwindle because, like any other provider of a public good, it will share the returns to its lawmaking efforts with other member states whose firms will piggyback its corporate law. In practice, however, any weakening of the incentives of British lawmakers as a result of incorporations by foreign firms will likely be negligible. To be sure, the desire to stimulate the economy is, by the British government's own account, a source of motivation to develop corporate law. But this motivation is only one of many reasons that account for the present state of British corporate law, and not necessarily the most important reason. Indeed, the United Kingdom does not appear to be the most active member state in using corporate law to compete for investments, and most of the features of its corporate law that appeal to incorporators date long before this competition assumed the proportions it has today. To expect that corporate lawmaking in the United Kingdom will stall as a result of incorporations by foreign firms is just not realistic.

[211] It is possible that private firms need different corporate law than public ones. *See, e.g.*, Robert Charles Clark, Corporate Law 234-38 (1986) (advocating greater tolerance towards usurpation of corporate opportunities by insiders in private firms than by insiders in public firms). The American experience shows, however, that while it is mainly public

likely receive less attention from lawmakers than they did prior to the departure of their peers.[212]

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

One mechanism that could sustain the existing momentum is adaptation of the market to the changed legal environment.[213] The intense competition for investments that economic integration has fostered in the European Union may have altered the existing institutional and political map, and introduced new actors that would want to see the current legal trend continued. In Italy, for example, many new business leaders, and more than one leader of the old business aristocracy, have jumped on the corporate governance bandwagon;[214] foreign investment banks have entered the securities and mergers and acquisitions markets;[215] local banks have converted to the new gospel of shareholder capitalism;[216] and the newly privatized stock exchange has

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firms that incorporate outside the state which they operate, half of public firms remain incorporated instate. *See supra* note 90.

[212] The possibility that legislators will be glad to be relieved of the pressure to reform local law and take the blame when it fails is real. To a certain extent it has already been demonstrated in the changes that Germany made to its corporate accounting rules in 1998 to enable German firms to list their securities in the United States and become subject to American securities law and listing rules. *See supra* note 105. For the argument that jurisdictions with less developed markets and corporate law can benefit from allowing local firms to piggyback more developed markets and corporate law abroad, see Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets, 47 J. Fin. Econ. 243 (1998); Edward B. Rock, Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Markets, 2 Theoretical Inquiries L. 711 (2001).

[213] *See generally* Deeg, *supra* note 41.

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

[215] *See* Mediobanca on the Back Foot, Economist, Jun. 23, 2001.

[216] *See* Heather O'Brien, IntesaBCI, Lazard Link in Italy, Daily Deal, Sept. 10, 2002.

become a proponent of reform.[217] Similarly, in Germany, formerly creditor-oriented banks have embraced the corporate governance movement by shifting much of their operations from corporate lending to investment banking;[218] formerly corporatist managers have become more attuned to shareholder value as a result of the growing popularity of stock option compensation;[219] and formerly insular employees have started to invest their own pension money in stock.[220] To be sure, the interests of these groups continue to diverge, but the gap between them is narrower than it used to be.[221]

The momentum can also be fueled by the companies that will remain practically locked in their home member states notwithstanding the freedom to incorporate abroad. Numerous companies may find themselves in this position.[222] They will probably include, among others, small and midsize companies for which the cost of incorporating abroad will not be justified; companies whose managers, employees, or creditors resist reincorporation; large companies that wish to be able to use their local political clout for shaping corporate law; and companies intent on avoiding the jurisdiction of foreign courts and regulators, which may extend to matters unrelated to corporate internal affairs.

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[217] *See* Deeg, *supra* note 41, at 188.

[218] *See supra* note 33.

[219] *See* John W. Cioffi, Expansive Retrenchment: The Regulatory Politics of Corporate Governance Reform and the Foundations of Finance Capitalism, *in* The State after Statism: New State Activities in the Age of Globalization and Liberalization (Jonah D. Levy ed., forthcoming 2005) (describing the growing acceptance in the 1990s of shareholder primacy by managers of corporations with global operations, such as Daimler Benz and Siemens).

[220] *See* John C. Cioffi & Martin Höpner, The Political Paradox of Finance Capitalism: Interests, Preferences, and Center-Left Party Politics in Corporate governance Reform (Working Paper, Sept. 15, 2004).

[221] For a recent account of the persistence of old traditions in German corporate boards, see Patrick Jenkins, The Clubby World of German Business Refuses to Accept New Membership Rules, Fin. Times, Aug. 28, 2004, at 20. In reality, the spread of the corporate governance movement has been uneven across firms. Thus, while it was pressure from the corporate sector that drove Germany and the Scandinavian countries to block the inclusion of a ban on the use of dual-class stock as antitakeover defense (see *infra* notes 226-227), some companies in these same countries have recently decided to declassify their stock voluntarily. *See* Paul Betts, Companies Start to See the Case for Fairer Votes, Fin. Times, Feb. 17, 2004, at 20 (reporting voluntary decisions by L'Oréal in France, ABN Amro in the Netherlands, Nokia in Finland, and SAP and Metro in Germany to scrap dual-class stock capitalization).

[222] *See supra* Section III.A.3.

All of these companies will be captives of their home member states' corporate laws. As the freedom to choose where to incorporate will be of little relevance to them, the pressure on their home member states to satisfy the need for modern law will remain. Much of the resulting legislation will be uncontroversial. It will involve making the law more flexible, adapting it to technological and economic developments, and improving the effectiveness of the institutions supporting it.[223] These uncontroversial attributes of corporate law are important. In the relatively uniform landscape of state corporate laws in the United States, they appear to tip the scales for incorporation decisions.[224] And in the European Union, these attributes already figure prominently in discussions by corporate counsel of the possibilities that incorporation abroad presents.[225]

Legislation promoting the interests of shareholders at the expense of managers, employees, or creditors will meet with greater resistance. The persistence of employee board representation and antitakeover defenses in various member states demonstrates as much. But this does not mean that member states that have traditionally guarded the interests of managers, employees, or creditors will continue to do so in an unqualified way. At the urging of local managers, for example, Germany fought the inclusion of a ban on antitakeover defenses in the European Union takeover directive,[226] and passed a law expressly making antitakeover defenses legal. This did not stop Germany from

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[223] Flexibility-increasing rules range from technical issues like using electronic communication to hold virtual shareholder meetings to substantive issues like designing hybrid securities. A recent example is the ordinance signed by the French president in 2004 to modernize the country's securities law by removing procedural constraints on secondary stock offerings, enabling issuers to define the terms of preferred stock, and simplifying the treatment of convertible stock. *See supra* notes 90-91 and accompanying text.

[224] *See* Kahan, *supra* note 174 (presenting evidence consistent with the argument that American firms tend to incorporate in states with flexible corporate statutes and effective courts).

[225] *See* Debevoise & Plimpton, *supra* note 163 (discussing the benefits for bilateral joint ventures of avoiding supermajority voting requirement for issuing new stock, and the benefits for private equity investors of avoiding restrictions on the issuance of redeemable or convertible preferred stock); Recent Legal Developments in the European Union Regarding Cross-Border Transactions, Jones Day Memorandum to Clients (Apr. 2004), http://www1.jonesday.com/FILES/tbl_s31Publications/FileUpload137/1188/Recent%20Legal%20Develop.pdf (same).

[226] *See* Daniel Dombey, European Parliament Backs Takeover Directive Compromise, Fin. Time, Dec. 17, 2003, at 4 (reporting that Germany blocked the inclusion in the takeover directive of a ban on antitakeover defenses at the behest of large manufacturers like BASF and Volkswagen).

adopting corporate governance reforms of which managers were less critical. Sweden also campaigned against banning antitakeover defenses in the takeover directive under pressure from local industry.[227] This did not stop the Swedish financial markets minister from publicly chastising local industry for not responding to corporate scandals and threatening to address the problem with legislation if this failure persists.[228] More generally, the quest for investments may well continue to lead member states to keep updating their laws and replicating shareholder protection available elsewhere. But it is local companies that will provide the impetus for doing so, not companies that operate abroad.[229]

2. The Effects on Firms

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

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

It is hard to tell which of these two possible outcomes will materialize. One can reasonably predict, however, that even if the latter

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[227] *See* Christopher Brown-Humes & Clare McCarthy, Family Fortunes Face Brussels Power Shift, Fin. Times, May 15, 2003, at P11 (reporting that Sweden, Finland, and Denmark blocked the inclusion in the takeover directive of a ban on dual-class stock capitalization under pressure from industrial barons such as the Walenberg family).

[228] *See* George, *supra* note 130.

[229] In principle, firms locked in their home member states may pressure lawmakers to reform local corporate law to help them compete for capital with local firms that incorporated abroad. But the pressure on lawmakers is likely to be stronger when no local firm can incorporate abroad and all firms rely on local corporate law for attracting foreign capital.

outcome occurs, the cost it will impose on firms that do not incorporate abroad will be smaller than the benefit it will confer on firms that do incorporate abroad. The reason is twofold. On the one hand, lawmakers driven by the desire to stimulate the local economy will have a strong interest in maintaining the quality of corporate law if a significant number of local firms with a pressing need for it cannot incorporate abroad. On the other hand, as both logic and experience in the United States suggest, firms that do incorporate abroad tend to have a greater need for corporate law more than firms that incorporate locally.

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

3. Competition for Incorporations as a Complement

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

However, it is far from obvious that any member states will decide to compete for incorporations, given the high costs and low benefits of doing so. Rather telling in this regard is the fact that none of the member states regarded as potential competitors have positioned themselves to compete or have stated an intention of doing so. No member state has even bothered to abandon the real-seat rule to compete for incorporations. This inaction is notable considering the time that has passed since member states were put on notice that the days of the real-seat rule across the European Union were numbered following the recent decisions of the European Court of Justice.

In 1986, the European Court of Justice ordered the Dutch authorities to recognize a British company operating in the Netherlands.[230] The court reiterated its position to the Danish authorities, to the German authorities, and again to the Dutch authorities in subsequent decisions in 1999,[231] 2002,[232] and 2003.[233] The decisions stirred a storm among academics. A flurry of commentary examining the new reality from all possible angles quickly filled the pages of legal journals. Since the rewards of early entry are a lesson from Delaware's experience, one would have expected a mad rush to scrap the real-seat rule and bid for foreign incorporations.[234] But member states showed no interest in competing. There was no mad rush, not even a lazy stroll. There was no reaction at all. Soon member states will have no choice but to delete the real-seat the rule from their books. The European Commission is already drafting a directive requiring them to do just that. But compliance with this requirement should not be mistaken for competition for incorporations. European capitals may have already revealed their lack of interest in this regard during two decades of apathy.

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

CONCLUSION

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

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[230] *See Segers*, *supra* note 6. A subsequent decision upholding British restrictions on the relocation to the Netherlands of the corporate headquarters of a company incorporated and headquartered in the United Kingdom caused temporary uncertainty about the direction that the court was taking. *See* Case 81/87, The Queen v. H.M. Treasury and Commissioner of Inland Revenue, ex parte Daily Mail and General Trust PLC, [1988] E.C.R. 5483.

[231] *See Centros*, *supra* note 6.

[232] *See Überseering*, *supra* note 6.

[233] *See Inspire Art*, *supra* note 6.

[234] *See* Klausner, *supra* note 193, at 841-47; Romano, *supra* note 116, at 37-44.

Normally, the rate of legal innovation and diffusion, and the degree to which the law serves shareholders, can be expected to be higher in jurisdictions that pursue incorporations. In the United States, for example, Delaware appears to be consistently more aggressive than other states in innovating and copying innovations from others. Other states are slower to adopt changes because they do not pay as much attention to their laws. Delaware also appears to be more careful in balancing shareholders' preferences against managers', as evidenced by its decision not to match the potent antitakeover statutes that some other states adopted with a similarly potent statute of its own.[235] Other states have more powerful antitakeover statutes because local managers lobby for their enactment while out-of-state shareholders are largely ignored.

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

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[235] *See* Kahan & Kamar, *supra* note 1, at 740; William J. Carney, The Political Economy of Competition for Corporate Charters, 26 J. Legal Stud. 303, 754-55 (1997); Romano, *supra* note 116, at 59.