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REGULATORY COMPETITION IN EU CORPORATE LAW AFTER *INSPIRE* ART: UNBUNDLING DELAWARE'S PRODUCT FOR EUROPE

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Regulatory Competition in EU Corporate Law after *Inspire Art*: Unbundling Delaware's Product for Europe

Abschied vom Verbundprodukt Delaware

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Abstract

The decisions of the European Court of Justice in *Centros* and then in *Inspire Art* open up the possibility of regulatory competition in European corporate law. Now that EU Member States have to recognize each other's charters, some Member States could enact and enforce corporate law preferred by shareholders, managers or both, and thus lure corporations away from other Member States with less attractive corporate law.

The European debate after *Inspire Art* will in some ways resemble the U.S. debate over the "Delaware effect" on corporate law over the past seventy years. Implicit in much of this debate, however, is the assumption, based on the U.S. experience, that regulatory competition in corporate law necessarily means that Member States will offer *both* their corporate law and their judicial system to managers and investors in other Member States who choose to incorporate abroad. Regulatory competition under this assumption requires the successful provider of corporate law to offer both an attractive statute and specialized courts to interpret that statute in a predictable manner so managers and investors will want to incorporate in that jurisdiction.

This article suggests that the European experience with jurisdictional competition, at least in the short term and perhaps for longer, could be different from that in the United States. We make both a positive and a normative statement that the process of regulatory competition in corporate law in Europe will not and should not follow the American example in all aspects.

Using a theoretical framework of New Institutional Economics, we relax the assumptions in neoclassical economics of perfect information, perfect rationality and zero transaction costs. We also recognize the impact of path dependence and the importance of a learning process to designing regulatory and adjudication frameworks. Furthermore, we are aware that even optimal solutions to regulatory problems can become unstable and suboptimal over time. Although there are many ways in which, for these and other reasons, the European experience with corporate law could be different from that in the United States, we focus in this article on one difference in particular. In the United States, incorporation in Delaware means that corporate law cases are litigated in Delaware. Delaware thus not only provides corporate charters but also its case law, and the user ordinarily must take a bundled product that includes substantive law (statutory and case law) together with adjudication. This bundling of statutory law and adjudication might, however, cause difficulties in Europe. We suggest that Member States are most likely to succeed in the regulatory competition following *Centros* and *Inspire Art* if they unbundle the corporate law product and allow buyers of

corporate charters to choose the corporate law of the Member State of incorporation but have disputes under that law adjudicated elsewhere, preferably by arbitration panels.

A number of factors make it difficult for Member States to offer adjudication to managers and investors in other Member States. These include (i) language barriers (particularly for Member States whose courts do not do business in English), (ii) differences between common law and civil law approaches to adjudication, (iii) procedural differences between courts of Member States that are greater than those between Delaware and other US states, and the fact that these differences discourage lawyers from recommending to their clients incorporation in other Member States, (iv) the cost to a Member State of building specialized judicial expertise in corporate law, (v) incomplete information about real or perceived judicial bias, (vi) uncertainty concerning conflict of laws within the EU, (vii) uncertainty about mutual recognition of judgments within the EU, and (viii) the fact that an effective adjudication system will require a learning process and that national judges could be “poor learners” about the complexities of applying national corporate law to managers and investors in other countries.

Designing strategies to overcome these barriers to a Member State entering the market for adjudication in addition to the market for corporate statutes may be a realistic long-term objective. This article suggests, however, that Member States should also explore strategies to offer their corporate statutes without adjudication by national courts and instead facilitate alternative methods of adjudication. Although it is possible to allow disputes under one Member State’s corporate law to be decided by the local courts of another Member State (probably the “seat” of the corporation), for a variety of reasons we find this to be an unattractive alternative. A more attractive alternative is adjudication by panels of professional arbitrators who specialize in the corporate law of a particular Member State, but who could be citizens of different Member States, and who would apply uniform procedural rules determined by an arbitration association rather than by national courts. This alternative requires that Member States allow corporate charters to provide for arbitration of disputes over corporate internal affairs. While national courts in the Member State of incorporation could do this by routinely enforcing arbitration awards, specific provision for arbitration in corporate statutes is preferable. Then, if a Member State where a corporation has its principal place of business or some other Member State were to try to make the arbitration clause unworkable under its own conflict of laws principles, the Member State of incorporation and private parties could claim, probably successfully, that frustration of the arbitration clause was not in compliance with the right of establishment as interpreted by the ECJ in *Inspire Art*.

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By Christian Kirchner, Richard W. Painter and Wulf Kaal

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A. Introduction

Until very recently, many countries in the EU applied the “seat theory” under which a corporation is governed under the corporate law of its principal place of business or “seat”. This contrasts with the “incorporation theory” predominant in the United States, under which a corporation, regardless of its principal place of business, may incorporate in the jurisdiction of its choosing.

These two approaches to corporate law allow for different levels of regulatory competition among jurisdictions seeking benefits of attracting corporate charters away from other jurisdictions (franchise taxes, markets for legal services, etc.). Seat theory allows for regulatory competition, but only with respect to the total package of laws and regulations (e.g. tax law, labor law, antitrust law and corporate law) that a jurisdiction offers to a business coming within its borders (this type of regulatory competition is referred to by some commentators as Type A competition¹). Competition with respect to corporate law alone in

¹ See e.g. Klaus Heine and Wolfgang Kerber, *European Corporate Laws, Regulatory Competition and Path Dependence*, 13 European Journal of Law and Economics (2002).

this context is impractical, because a corporation cannot choose the corporate law of a state without locating its principal place of business there and thus becoming subject to that jurisdiction's other laws. Incorporation theory, by contrast, allows for competition with respect to corporate law alone (Type B competition²). At least in theory,³ this promotes regulatory competition between states over the charters of corporations having their seat elsewhere, whereas the "seat theory" inhibits this type of regulatory competition.

Regulatory competition is predicated on different jurisdictions having different legal rules, and this lack of uniformity imposes some transaction costs. For example, private actors have to understand the laws of different jurisdictions in order to decide where to locate, and then additional effort is required to make sure that transactions are conducted according to the law of the chosen jurisdiction, which may be different from the jurisdiction private actors are used to. When disputes arise, legal rules must be applied to a particular set of facts, and if the chosen jurisdiction does not provide clear answers, private parties, lawyers and judges speculate as to the extent legal rules in other jurisdictions provide guidance and whether this guidance should be followed. Sometimes the same private parties may choose the rules of several different jurisdictions for different purposes, giving rise to additional complications if it is not clear which jurisdiction's rules apply in a particular instance.

Policy makers thus sometimes seek to reduce these and similar transaction costs within an integrated economic area by promoting uniformity rather than diversity of legal rules, whether through EU directives, or in the United States through federal preemption and undertakings to enact uniform state laws. Such efforts, to the extent successful, impose uniformity and undermine regulatory competition within the economic area concerned, although competition can still come from outside.⁴ Before *Centros* and *Inspire Art* introduced the possibility of Type B regulatory competition in Europe, harmonization of legal rules was widely believed to be the best way to overcome transaction costs of doing business across borders in Europe (the more harmonization there was, the less Type A competition there would be and the less effort managers and investors would expend trying to understand how law affects their decision about where to locate). In the area of corporate law, Art. 44 sec. 2 of the EC-Treaty (former Art 54 sec. 3 lit g) thus provided for harmonization of the law of Member States to attain a comparable level of protection for shareholders and creditors in different Member States. The EU has also established a statutory framework for a European Company, the so called SE (*Societas Europaea*), which allows companies to be registered as an SE under precisely defined circumstances, including restrictions on the freedom to transfer registration to another Member State from the Member State in which the SE was first registered.⁵ Arguably, such harmonization by public ordering either at the Member State or

² See *Id.*.

³ Some commentators argue that in practice, Type B competition in the United States has resulted in a single jurisdiction, Delaware, dominating the market for out-of-state corporate charters and facing relatively little competition from other jurisdictions. See text accompanying notes 44-45 *infra*.

⁴For example, more non-U.S. firms may decide to list their securities outside the U.S. in response to federal preemption of state corporate law in the Sarbanes-Oxley Act of 2002. See Larry E. Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on US Law*, 3 J. Corp. L. Stud. 299 (2003); Larry E. Ribstein, *Cross-Listing and Jurisdictional Competition* (working paper) (on file with authors).

⁵See Council Regulation on the Statute for a European Company of the European Union, adopted October 8, 2001, OJL 294, November 10, 2001 at 1-21, in force October 8, 2004, complemented by the Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, adopted October 8, 2001, OJL 294, November 10, 2001 at 22-32.

EU level, lowers transaction costs and creates synergies, because corporations in different jurisdictions supposedly will operate under more similar corporate laws.

Harmonization, however, has been a burdensome undertaking in the EU. Despite decades of trying at the national and EU level, laws in the various Member States are still far from similar. With the recent expansion of the EU to 25 Member States and more to come, harmonization has become increasingly difficult. It is also apparent that harmonization has its own transaction costs as Member States are forced to adjust their rules to EU “norms.” Despite all the effort at harmonization and the related costs, an investor in Member State A who intends to invest in Member State B still incurs significant information gathering and transaction costs, and these costs can still be a disincentive to invest. It has yet to be seen whether managers and investors view the SE as a viable alternative, but initial reaction has been less than enthusiastic, perhaps because the rules governing an SE are the product of years of negotiation and political compromise rather than a response to market forces.⁶ An alternative approach of harmonization via private ordering in corporate charters that contract around unwanted rules in a given jurisdiction’s corporate law, would also reduce transaction costs, but in European jurisdictions this alternative has in large part not been legally permitted (the SE is for the most part the only “opt in” alternative to national law).⁷ As skepticism thus grows in Europe about the benefits of harmonization and the centralization of power at the EU level that harmonization involves, there is renewed academic and political interest in exploring possibilities for going in the opposite direction of expanding rather than contracting the scope of regulatory competition while still minimizing transaction costs. There is also renewed speculation about whether regulatory competition might actually improve legal rules.⁸

Recently, the European Court of Justice (ECJ) gave the regulatory competition side of this debate a boost when it decided in *Centros* and *Inspire Art* that provisions in the Treaty of Rome on the freedom of establishment enable companies formed in accordance with the law of a home country of incorporation to pursue substantial economic activities in a host country other than the home country.⁹ The ECJ effectively decided that the incorporation theory prevails over the seat theory. The “public policy” test previously applied to interpret Art 46 of the EC Treaty to allow Member States to adhere to the seat theory, has been abandoned in favor of a stricter “public interest” test under which a host country now has to explain that national legal provisions it seeks to impose on corporations from other Member States meet

⁶The SE is intended as a replacement only for national corporate law, yet may still be incompatible with other areas of law in various Member States such as insolvency law, labor law, capital market law, etc.

⁷By contrast, a large body of corporate law in the United States is treated as “default” rules that can be contracted around in corporate charters.

⁸ See Christian Kirchner, *Zur Ökonomik des legislatorischen Wettbewerbs im europäischen Gesellschaftsrecht* (2004) (on file with authors), citing relevant literature.

⁹ The ECJ reached a similar conclusion in *Überseering BV v. Nordic Construction Company Baumanagement*, Case C-208/00, n.y.r. (2002). *Überseering* was incorporated in the Netherlands but owned exclusively by German investors who transferred the company’s centre of administration from the Netherlands to Germany. When *Überseering* sued *Nordic*, the German courts held that because *Überseering* was not properly registered under German corporate law, it had no standing. The ECJ, however, decided that a company legally established according to the law of one Member State cannot, according to EC Treaty Articles 43 and 48, be denied standing to sue and be sued in another Member State.

overriding public interests.¹⁰ Unless a Member State can prove that this “public interest” test is satisfied, the right of establishment will strike down all its national provisions that impede a company incorporated in another Member State from doing business within its borders.

If the ECJ’s apparent embrace of the incorporation theory leads significant numbers of private actors to take advantage of the opportunity to incorporate outside their own Member State’s borders,¹¹ Type B regulatory competition in corporate law should follow.¹² There is some indication that this may be happening, at least with respect to incorporation in the U.K. (at least 141 companies with German names containing the designation “GmbH”, used for doing business in Germany, have been formed as private limited companies under U.K. company law in the four years since the ECJ first addressed the incorporation theory in

¹⁰ The “public policy” test previously used to apply Art. 46 EC permitted “Member States to restrict the freedom of establishment of foreign nationals by adopting provisions laid down by law, regulation or administrative action, in so far as such provisions are justified on grounds of public policy, public security or public health”.

Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., ECJ Case C. 167/01 at note 4.

Because this public policy test failed to preclude Dutch rules that impeded freedom of establishment, the Court in *Inspire Art* established a new test that required that the Member State show an “overriding reason relating to the public interest.” *Id* at note 107. While the *Centros* and *Inspire Art* decisions clearly uphold the freedom to incorporate under the laws of another Member State, an unresolved issue is the extent to which these ECJ decisions also make it possible to change the Member State of incorporation of an existing corporation, for example through a merger with a new corporation incorporated in another Member State. The existence of regulatory competition in corporate law after *Centros* and *Inspire Art* does not turn on how this question is resolved (it may be resolved differently under the laws of different Member States unless the ECJ speaks on the issue), but the amount of such regulatory competition in Europe will be affected by whether existing corporations, in addition to new corporations, have jurisdictional choice with respect to corporate law.

¹¹ Lawyers are already recommending that clients consider incorporation in the UK, or possibly the Netherlands. See e.g. The Debevoise & Plimpton Private Equity Report, Spring 2004 at 4 (“The two court rulings also pave the way to avoid certain issues that may arise out of mandatory provisions of European continental company laws that may not be desirable in a given case”). See *Id.*, citing problems with German corporate law, including codetermination, rigid procedures for issuing share capital (particularly for in-kind contributions), strict rules on capital maintenance, and a required 75% supermajority shareholder vote in favor of capital increases, mergers and certain other corporate actions, posted at www.debevoise.com/db30/cgi-bin/pubs.

¹² Some Member States are beginning to react to the threat of competition from the U.K. by making changes in their own corporate law. See Peter Mankowski, *Entwicklungen im Internationalen Privat- und Prozessrecht 2003/2004* (Teil 1), 7 *Recht der Internationalen Wirtschaft* 481, 486 (2004) (pointing out that after the *Inspire Art* decision, France lowered its minimum capital requirement for its SARL to one Euro, presumably in order to make its corporate law more competitive with the English Limited Company, and that Spain had months before the *Inspire Art* decision introduced a new corporate form, the Sociedad Limitada Nueva Empresa). Some German scholars suggest following the examples of France and Spain with long overdue reforms to the law governing the GmbH, and following the U.K. and France by allowing on-line company registration. See Erich Schanze and Andreas Juettner, *Die Entscheidung fuer Pluralitaet: Kollisionsrecht und Gesellschaftsrecht nach der EuGH-Entscheidung “Inspire Art”, Die Aktiengesellschaft*, 661, 671 (December 2003).

Centros; only 4 such companies predated the ruling in *Centros*).¹³ However, it may be premature and even misleading to compare the projected path of regulatory competition in Europe to that in the U.S., particularly when both regulatory competition and economic integration are at a stage in Europe that is very different – perhaps more closely resembling the U.S. of the late 1800’s than the U.S. today. Factors such as imperfect information, bounded rationality and transaction costs may affect corporate law differently in Europe than in the U.S., and Europeans will also undergo a different learning process when they experiment with corporate law statutes and adjudication systems.¹⁴

More specifically, a number of factors discussed more fully in Section D below may make it difficult for a Member State to mimic the winner of the U.S. regulatory competition – Delaware -- in exporting a bundled package of statutes and courts that adjudicate disputes under those statutes. For various institutional reasons, it may be better for disputes to be adjudicated in a forum, such as a panel of professional arbitrators, other than the courts of the Member State whose corporate laws apply.¹⁵ This Article explores the reasons for this difference as well as various strategies that could be used by Member States to offer an unbundled product of corporate law: law (principally statutes) without adjudication of disputes by national courts of the Member State of incorporation.

¹³ This process apparently sped up after the ECJ’s decision in *Inspire Art*. In the ten months after the *Inspire Art* decision, at least 48 such companies with German names and the designation GmbH in their names were formed as private limited companies under U.K. law. See Companies House, CD-ROM Directory (August 2004) (containing information on over 1.7 million registered companies) (on file with authors). Some of these companies, however, may also do at least some business in the U.K, meaning the incorporators are not choosing the private limited company form simply in order to use U.K. law. It is also not clear that investors in these private limited companies have entirely opted out of German corporate law, as some of them may be affiliated with, or controlled by, a GmbH formed under German law.

¹⁴ New Institutional Economics recognizes that transaction costs, imperfect information and bounded rationality affect rule makers as well as private actors, and emphasizes the importance of overcoming these limitations through a learning process of experimentation with different rules and observing the results of this experimentation. See generally Ronald Coase, *The New Institutional Economics*, 140 J. INST. & THEO. ECON. 229, 229–31 (1984) (describing some important features of New Institutional Economics); Douglas C. North, *The New Institutional Economics*, 142 J. INST. & THEO. ECON. 230 (1986) (describing New Economics); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (New York 1985) (describing Old and New Economics); Karl Homann, K & Christian Kirchner, *Ordnungsethik*, in *Jahrbuch für Neue Politische Oekonomie*, Bd. 14, *Von der Theorie der Wirtschaftssysteme zur Oekonomischen Systemtheorie*, at 189-211 (von Philipp Herder- Dornecih, Karl-Ernst Schenk, Dieter Schmidtchen ed., 1995); EIRIK G. FURUBOTN & RUDOLF RICHTER, *INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS* (Ann Arbor 1997).

¹⁵ The distinction we make here, that between choice of law and choice of forum, is well known to drafters of commercial agreements. Each is usually addressed by a separate clause in a contract. By “unbundling” corporate law we mean separating choice of law from choice of forum. The state of incorporation determines choice of law, and ex-ante contractual arrangements (probably in corporate charters) address choice of forum. A Member State that allows private actors to make this choice, we suggest, could have a competitive advantage in attracting corporate charters over a Member State that insists on bundling its forum with its corporate law.

We are not predicting here that Type B regulatory competition in corporate law will in fact take place in Europe. For many reasons, including the conservatism of European managers who may not want to incorporate abroad and the fact that Member States may use tax law,¹⁶ capital market law¹⁷ and listing requirements¹⁸ or other mechanisms to frustrate Type B regulatory competition after ECJ's rulings in *Centros* and *Inspire Art*, the seat theory may continue its de facto dominance. Even the ECJ itself could possibly retreat from a wholesale embrace of Type B regulatory competition.¹⁹ Opponents of regulatory competition could prevail upon the European Commission and Parliament to react to *Centros* and *Inspire*

¹⁶ Member States could impose adverse tax consequences on mergers between domestic corporations and holding companies that lacked a business purpose other than changing the domestic corporation's state of incorporation. If such a tax was not imposed in a discriminatory manner (e.g. only on mergers with foreign holding companies), the tax probably would not violate the freedom of establishment guaranteed by the Treaty. Such a tax would not prevent new corporations with a principal place of business in one Member State from incorporating in another Member State, but could prevent existing corporations from moving.

¹⁷ Capital market law is probably unaffected by the *Centros* and *Inspire Art* holdings, and thus will remain that of the jurisdiction where a securities transaction takes place (for most issuers of securities, this would be the principal place of business or where they list their securities). For issuers incorporated outside of their principal place of business, conflict of laws problems between corporate law and capital market law are a real possibility, and a Member State could intentionally make these problems worse by expanding the reach of its capital market law to intrude on subject matter normally under corporate law. Managers and investors might choose to avoid these problems by incorporating at home. See further discussion of "incomplete information about conflicts of laws" in Section D below.

¹⁸ A stock exchange, such as the Frankfurt Stock Exchange, could refuse to list companies incorporated in other Member States or in Member States where they do not have their principal place of business. Most stock exchanges are private actors, and even if stock exchanges were to act under government pressure, such restrictions probably would not violate the freedom of establishment in the EC Treaty as interpreted in *Inspire Art*. However, a stock exchange that adopts such listing restrictions would arguably put itself at a competitive disadvantage vis a vis stock exchanges that do not.

¹⁹ The language of the *Centros* and *Inspire Art* decisions leaves some room for retreat by the ECJ given remaining ambiguities associated with the "overriding reason relating to the public interest" test. See note 10 supra. Furthermore, there is debate about what recognition by one Member State of a charter from another Member State involves and what aspects of corporate law are governed by the state of incorporation as opposed to the Member State where the corporation has its principal place of business. See Holger Altmeyden, Schutz vor "europäischem" Kapitalgesellschaften, 3 Neue Juristische Wochenschrift 97 (2004) (summarizing the relevant literature and arguing that the corporate law of the Member State of incorporation for a foreign corporation doing all of its business in Germany would only apply to some aspects of the corporation's internal affairs, whereas German corporate law would apply to others, including important aspects of creditor protection and the law governing groups of corporations, or *Konzernrecht*). But see Otto Sandrock, Sitzrecht contra Savigny?, 17 Betriebs-Berater 897 (2004) (law of the state of incorporation should govern except under very limited circumstances). These and similar questions may have to be resolved by the courts of the Member States and ultimately the ECJ.

Art with further harmonization of corporate law in all Member States through directives.²⁰ It remains to be seen whether Type B regulatory competition will overcome these and other obstacles, an issue already discussed extensively in other scholarly work.²¹ Our objective here is to demonstrate that, if Type B regulatory competition in corporate law does succeed in Europe, it is more likely to succeed if Member States market the unbundled product of statutes without adjudication.

We also do not ignore the importance of adjudication or suggest that adjudication be left to chance. We rather propose that private ordering can better design an adjudication system than can public ordering by Member States marketing their corporate laws to managers and investors outside their borders. For want of a better term, we refer to the privately designed adjudication system that we envision for Europe as “arbitration.” Like arbitration now used in a wide variety of other commercial contexts, the adjudication model we envision has the flexibility often associated with private ordering. In some important aspects, including use of written opinions for cases involving public companies²² and reliance on precedent, however, our model resembles adjudication by national courts more closely than procedures used today in some forms of arbitration. The objective would not necessarily be adjudication that is faster or cheaper than adjudication in national courts, but adjudication that would be more accurate, more efficient and easier to use.

²⁰ The European Commission has already submitted a proposal for regulation of cross-border mergers in the EU. See Proposal for a Directive of the European Parliament and of the Council on cross border mergers of companies with share capital. COM (2003) 703(01).

²¹ See e.g. K. Heine, *Regulierungswettbewerb im Gesellschaftsrecht Zur Funktionsfähigkeit eines Wettbewerbs der Rechtsordnungen im europäischen Gesellschaftsrecht* (2003); Ch. Kersting, *Rechtswahlfreiheit im Europäischen Gesellschaftsrecht nach ”Überseering”*, NZG 9 ff. (2003); E. Schanze and A. Jüttner, *Die Entscheidung für Pluralität: Kollisionsrecht und Gesellschaftsrecht nach der EuGH-Entscheidung ”Inspire Art”*, Die Aktiengesellschaft 661 (2003); D. Zimmer, *Ein Internationales Gesellschaftsrecht für Europa*, *Rabels Zeitschrift für ausländisches und internationales Privatrecht* 298 (2003); H. Eidenmüller, *Wettbewerb der Gesellschaftsrechte in Europa*, 23 *Zeitschrift für Wirtschaftsrecht* 2233 – 2245 (2002); E. Steindorff, *Centros und das Recht auf günstigste Rechtsordnung*, 54 *Juristenzeitung* 1140 (1999); Werner Ebke, *Das Centros-Urteil des EuGH und seiner Relevanz für das deutsche Internationale Gesellschaftsrecht*, 54 *Juristenzeitung* 656 (1999).

²² See text accompanying notes 104-105 *infra*.

B. The Framework for Regulatory competition

I. The Exit Option

Persons domiciled in a particular state have various ways of influencing political decisions, including voting and lobbying. They also have an exit option.²³ Unsatisfied persons thus can evade political decisions, including legal rules they do not like, by emigrating. In doing so, they exert influence over rules in the jurisdiction from which they emigrated as well as the jurisdiction into which they immigrate.²⁴ Even the threat to emigrate can impact legislation by creating incentives for the legislator to establish rules that avoid emigration and its detrimental effect on persons who remain in the jurisdiction (lower tax revenues, fewer jobs, etc.).²⁵ Emigration can also damage the prestige of a jurisdiction and have severe internal political implications, giving rule makers additional incentive to avoid it. Immigration conversely can lead to corresponding benefits for a jurisdiction, giving rule makers an incentive to attract immigration.

The same is true of emigration and immigration of corporations. If a corporation changes the physical location of its facilities, its employees and other resources often migrate with it. If, on the other hand, a corporation changes only its jurisdiction of incorporation while leaving its facilities where they are, most employees and resources will not move, but some persons and resources related to the jurisdiction of incorporation, including legal services and corporate franchise taxes, will migrate. Although the impact on a jurisdiction of emigration or immigration of legal persons may not be as great as in the case of natural persons, rules governing legal persons can still be a parameter by which different jurisdictions compete.

Whether and how a jurisdiction competes with respect to legal rules is determined in large part by the incentives of private and public actors within the jurisdiction. Lawyers, for example, care whether the jurisdiction's corporate law is attractive to users and creates demand for their services.²⁶ Local taxpayers benefit if better corporate law increases tax

²³ See C. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. Pol. Eco. 416 (1956) (developing a framework for analysis of jurisdictional competition for the mix of revenues and expenditures) (assuming that consumer-voters are fully mobile, "the appropriate local governments, whose revenue-expenditure patterns are set, are adopted by the consumer-voters. While the solution may not be perfect because of institutional rigidities, this does not invalidate its importance. The solution, like a general equilibrium solution for a private spatial economy, is the best that can be obtained given preferences and resource endowments."). Although the Tiebout model does not extend to jurisdictional competition concerning regulation, Tiebout's framework has influenced theoretical discussions of regulatory competition.

²⁴ See Christian Kirchner (1999).

²⁵ Type A regulatory competition from new Member States in labour law, for example, recently forced Germany, France and some other Member States to reconsider rules mandating high wages, high benefits and low work hours, after some domestic industries threatened to emigrate to Eastern Europe.

²⁶ In the U.S., the most easily identifiable group of private actors benefiting from, and influencing, corporate law in Delaware is lawyers, and lawyers are in large part responsible for the content of Delaware corporate law. See Jonathan R. Macey and Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 Texas L. Rev. 469 (1987); Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 Missouri Law Review 299, 328 (2004) (discussing lawyers' extensive role in writing Delaware corporate law). It remains to be seen, however, whether lawyers will have as substantial an impact on the future course of

revenue, whether from corporate franchise fees or revenue from income taxes on legal services, and thus reduce pressure on local tax rates. Managers and investors in businesses already incorporated within a jurisdiction also have an interest in substantive aspects of the jurisdiction's corporate law and may seek to influence the process by which the jurisdiction makes its law. Politicians, judges, law professors,²⁷ and other law reform advocates often have ideological concerns or professional ambitions that affect their outlook on corporate law. These interests each incur unique benefits and costs associated with changes in the jurisdiction's corporate law. They also collectively shape the jurisdiction's decisions about whether to change its corporate law.

Once a jurisdiction has corporate law that attracts a significant number of corporations from other jurisdictions, that jurisdiction's cost of maintaining and making periodic adjustments to that law will be relatively low (at least compared with the number of corporate charters in that jurisdiction).²⁸ On the other hand, a jurisdiction that has not previously attracted immigrating corporations would probably have to incur relatively high costs to make itself competitive. These costs are likely to be even higher if the jurisdiction offers a bundled product and has to make its judiciary competitive as well as its statutory scheme. A jurisdiction that does not start out in a dominant position thus may decide not to compete at all and risk losing some of its existing corporate charters rather than incur the costs of making changes to its corporate law that it otherwise would not make. If corporations are allowed to, and do, use the exit option by changing their legal domicile, the impact on substantive legal rules thus depends upon how jurisdictions react to migration, and on whether they react at all.

Indeed, some scholars argue that high costs of competing discourage other U.S. states from challenging Delaware's dominant position in the market for corporate charters.²⁹ In Europe no member state currently has an equivalent dominant position in the market for corporate charters that has emerged since *Centros* and *Inspire Art* were decided (the UK's apparent lead is a thin one, and does not extend to large publicly held corporations).³⁰ This

corporate law in Europe. The most publicized European view has for a long time been that lawyers exert more influence over public affairs, including law making, in the United States than they do in Europe. See Alexis de Tocqueville, *Democracy in America* 277 (A Knopf Ed. 1946) ([N]othing . . . can be more obscure and strange to the uninitiated than a legislation founded upon precedents . . . [The] American lawyer resembles the hierophants of Egypt, for like them he is the sole interpreter of an occult science.).

²⁷Law professors, through participation on government appointed commissions, play a significant role in law reform in some Member States such as Germany. They, and other law reform advocates, usually favor adoption of their own proposals into a jurisdiction's corporate law, not only because they believe their proposals are superior, but also because, once their proposals are adopted, professional advancement and consulting engagements are likely to follow.

²⁸ The costs, like the benefits of changing the jurisdiction's corporate law, are actually born not by "the jurisdiction" but by various public and private actors within the jurisdiction such as those described in the preceding paragraph.

²⁹ See Section D *infra* (discussing "barriers to entry").

³⁰ See note 12 *supra* and accompanying text (discussing foreign company incorporation in the U.K. after *Centros* and *Inspire Art*). The U.K.'s lead so far is principally with respect to the small closely held corporations that were the subject of the *Centros* and *Inspire Art* cases to begin with. No E.U. market leader for corporate charters of large public companies has yet emerged. See Companies House, CD-ROM Directory, *supra* note 12 (recording many instances of incorporation in the U.K. of corporations using the German term "GmbH" in their

may encourage one or more Member States to compete for corporate charters if they can do so at minimal cost. The response by at least some, and perhaps most, Member States, however, may be that competing for a dominant position in exporting corporate law is not worth it. Although only time will tell, it is conceivable that only one, or even none, of the Member States will make its corporate law attractive to corporations having a principal place of business elsewhere.³¹ It is also conceivable that if participating in Type B regulatory competition requires changes only to a Member State's statutes, but not to its adjudication system, more Member States may choose to participate.

II. Mobility Costs, Path Dependencies and Rule Switching Costs

Although it is possible to assume away the costs to a natural or legal person of changing jurisdictions, (as does the original Tiebout model of jurisdictional competition with respect to public expenditures),³² emigration and immigration incur costs. The relative costs of migration (Mobility Costs) for private actors are thus an important parameter in regulatory competition. These mobility costs differ depending on the private actors involved. One corporation incurs costs of reincorporating from, for instance, France to England, that differ from the costs that another corporation incurs reincorporating from France to England. The size of the corporation, its number of shareholders, its managers, its preferred language and other factors all influence the cost of moving from one jurisdiction to another.

Resources migrating with a company also influence mobility costs. Costs of moving resources make it more expensive for a corporation to migrate both physically and legally (to move its headquarters and facilities) than only to change its legal domicile. Even when only

name, but not a single instance of incorporation in the U.K of a corporation using the term "AG" which in Germany designates a publicly held company).

³¹ This gives rise to the question of how many competitors is enough. In the U.S. context, proponents of Delaware's corporate law presumably believe that one competitor is enough, particularly when there is a threat of competition if the substantive quality of Delaware's corporate law or adjudication apparatus were to deteriorate. Critics of Delaware law, on the other hand, might point to the lack of an actual competitor as a reason to doubt the substantive quality of Delaware's corporate law.

³² Although Tiebout's model of jurisdictional competition did not extend to regulatory competition, his model, and in particular its emphasis on migration as a tool for expressing preferences, has strongly influenced analysis of regulatory competition, and some of the many assumptions in Tiebout's model, such as full mobility and full information, also underlie many models of regulatory competition.. See Tiebout, *supra* note , at 419 (observing that the following assumptions are made:" 1. Consumer-voters are fully mobile and will move to that community where their preference patterns, which are set, are best satisfied. 2. Consumer-voters are assumed to have full knowledge of differences among revenue and expenditure patterns and to react to these differences. 3. There are a large number of communities in which the consumer-voters may choose to live. 4. Restrictions due to employment opportunities are not considered. It may be assumed that all persons are living on dividend income. 5. The public services supplied exhibit no external economies or diseconomies between communities. . . 6. For every pattern of community services set by, say a city manger who follows the preferences of the older residents of the community, there is an optimal community size. This optimum is defined in terms of the number of residents for which this bundle of services can be produced at the lowest average cost. This, of course, is closely analogous to the low point of a firm's average cost curve. . . . 7. The last assumption is that communities below the optimum size seek to attract new residents to lower average costs. . . ").

the legal domicile migrates, resources tied to the state of incorporation, such as legal services, could be more or less costly to relocate depending on the jurisdictions involved. If a company can migrate from one jurisdiction to another and still keep many of its resources in their present location, mobility costs will be lower. For example, a move from incorporation in England to incorporation in Ireland is cheaper if the corporation's English in-house lawyers can continue to handle problems under Irish corporate law. A German corporation's lawyers, however, might not be able to assist with problems under Irish law, making the move to Ireland for the German corporation more costly. Finally, mobility costs are probably higher if changing jurisdictions of incorporation means changing not just the applicable corporate law, but also the courts that will apply that law.

Still another factor is Path Dependence.³³ The corporation that gives up one jurisdiction and opts for another – presumably superior – jurisdiction has to take into account that its incorporation in the old jurisdiction and operation under that jurisdiction's laws may be viewed as a “specific investment” which is lost in case of changing to the new jurisdiction (in old terminology this would be referred to as a “sunk cost”-problem). The change of jurisdictions could be viewed by managers and investors as only making sense for the corporation if the discounted value of the improvement resulting from the change – the difference between costs and benefits of incorporating in the new jurisdiction compared to costs and benefits of incorporating in the old jurisdiction -- surpasses the costs of changing to the new jurisdiction, i.e. the cost of giving up the old specific investment and replacing it with a new one.

Path dependence may result from the fact that a corporation has gained expertise in handling legal problems within the old jurisdiction (a factor which at the very least may cause its lawyers to resist a change). But there may be reputational and emotional factors as well stemming from the national identity of a corporation registered and having its seat in a given Member State.³⁴ These factors are very likely to have a larger weight in Europe than in the United States, and they are especially important for the ‘old economies’ in Europe which have a long tradition of national corporate law. In the new Member States, especially those from Central and Eastern Europe, the situation may be different. A Latvian corporation, for example, might be more likely than a French corporation to reincorporate in the UK after *Inspire Art*, because the Latvian corporation is giving up less value in its home country corporate charter, considering the relatively recent origins of new Latvian corporate law and the likelihood that the future course of Latvian corporate law is not easy to predict. In France,

³³ For discussion of the impact of path dependence on the evolution of American corporate law, see Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 Harv. L. Rev. 641, 643-62 (1996); Lucian A. Bebchuk and Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan. Law Rev. 127 (1999). For discussion of the impact of path dependence on German corporate law, see Helmut Kohl, *Corporate Governance: Path Dependence and German Corporate Law: Some Skeptical Remarks from the Sideline*, 5 Columbia Journal of European Law 189 (Spring 1999). See also S.J. Liebowitz and S.E. Margolis, *Path Dependence, Lock-In, and History*, 11 Journal of Law, Economics and Organization 205 – 226 (1995); and G. Schreyoegg and J. Sydow (eds.) *Managementforschung 13: Strategische Prozesse und Pfade*, Wiesbaden (2003).

³⁴ Many German businesses keep the designation “GmbH” in their legal names after incorporating as private limited companies under U.K. law. See note 12 supra and accompanying text. This may be done in part in order to retain a “national identity” deemed important to their investors, managers or other constituents. Still, however, some critics refer to such entities incorporated in the U.K. as “cheap GmbHs” (“*Billig GmbHs*”). See Altmeppen, supra note 19 at 97.

corporate law, whatever its flaws, has a longer history and should be more predictable, making the problem of path dependence more important in the case of a French as compared to the Latvian corporation. A company incorporated in a jurisdiction without a well-established and functioning court system also will have a higher incentive to reincorporate in another jurisdiction than a company that has invested heavily in having its affairs adjudicated in a well-functioning court system in its present jurisdiction of incorporation.

In the United States the problem of path dependence may theoretically be the same, but the differences between various state corporate laws are not as significant in the U.S. as they are in Europe. This is true for U.S. adjudication systems as well, whereas European adjudication systems vary widely. Furthermore, reputational and especially emotional factors connected with national corporate identity are expected to be more important in Europe than in United States. Still, however, the impact of path dependence will vary throughout Europe. Corporations from some Member States, because path dependence has less impact on decisions of their managers and investors, are more likely to change jurisdictions than corporations from other Member States.³⁵

From the jurisdiction's perspective, it incurs costs when it changes its legal rules (collectively, "Rule Switching Costs"). These include the cost to taxpayers of drafting new rules, passing new rules through the legislature, publicizing the rules and judicial interpretation of the rules. Lawyers, judges, managers and other private actors within the jurisdiction incur costs of understanding, or running the risk of misunderstanding, the new rules. Politicians, labor union leaders and judges also run the risk of being blamed for unpredictable outcomes from the new rules. Law professors, who have built up expertise in, and have written publications on, the old rules, feel compelled to achieve equal proficiency in the new rules. In order for a jurisdiction to have an incentive to change its rules to attract immigration and deter emigration, the net benefits to the jurisdiction from the new rules, including from net migration in its favor must exceed its rule switching costs (or at least the private interests within the jurisdiction that realize a net benefit from switching rules must be able to exert more political influence than the private interests that realize a net loss).

Most important to the analysis in this paper, these rule switching costs are probably higher if the jurisdiction has to make substantial new demands on its courts as well as make changes to its statutes. Giving judges more cases to hear because more businesses choose to incorporate in the jurisdiction, or new tasks to perform such as hearing derivative suits and other group shareholder litigation, is not likely to be popular with the judges themselves. Incumbent judges also probably will not endorse a solution that responds to increased case load by hiring more judges, thus diminishing the prestige of their office. Judges also may not be receptive to suggestions that they improve efficiency by either specializing in corporate law or avoiding it altogether. A higher caseload may not even be popular with lawyers who argue cases in the courts (even if the total amount of legal business in the jurisdiction were to increase, some lawyers, perhaps the most senior and influential lawyers, may be *unhappy* with

³⁵Less pronounced path dependence could give corporations now incorporated in the new Member States a disproportionate role in determining which Member State's corporate law "wins" the jurisdictional competition, if these corporations are more likely to change incorporation jurisdictions. Their preferences may also determine important substantive elements of the "winning" jurisdiction's corporate law, such as the balance between the legal rights of investors and managers. On the other hand, the large number of corporations in some older Member States, such as Germany, may give these corporations a significant role in shaping the outcome of a post-*Inspire Art* jurisdictional competition, even if a lower proportion of them, because of presumably more path dependence, decide to reincorporate in another Member State. Their mere threat to reincorporate elsewhere may also influence the corporate law of their own Member State.

the increased workload).³⁶ Some judges and lawyers may furthermore be uncomfortable with the prospect of handling more cases involving litigants from other Member States, many of whom may speak another language and fail to appreciate procedural rules in their courts. Rule switching costs that adversely impact judges and lawyers may be lower, on the other hand, if at least some litigants, particularly litigants from other Member States, arrange for adjudication of disputes under corporate law statutes in another forum.

Specific mobility costs, path dependencies and rule switching costs that could affect jurisdictional competition in European corporate law are discussed in more detail in Section D below. For present purposes, the most important observation is that these costs are important, probably equally as important as substantive legal rules, in determining the actual migration patterns that are the outcome of jurisdictional competition. The intensity of regulatory competition thus as a general matter increases with the reduction of corporations' mobility costs and path dependencies and with the reduction of jurisdictions' rule switching costs. As explained more fully below, it is entirely possible, indeed probable, that private actors' mobility costs and path dependencies and jurisdictions' rule switching costs would be lower if jurisdictions competed with respect to an unbundled package of statutes only and allowed adjudication to be supplied elsewhere.

III. Type A, Type B And Unbundled Type B Regulatory Competition

Klaus Heine and Wolfgang Kerber, in their article *European Corporate Laws, Regulatory Competition and Path Dependence*, elaborate on the distinction between Type A

³⁶The assumption that lawyers favor rules that attract more corporate charters to the jurisdiction and increase demand for their services, and hence their workload, is not as obvious in the European setting as in the United States. Many European lawyers, like other Europeans, may value leisure more highly than their American counterparts. Older lawyers in particular may be predisposed toward reducing their workload (unlike their American counterparts, many European law firms still compensate lawyers based on a seniority system). Older lawyers may also worry that higher caseloads, new adjudication procedures and an inflow of litigants from other Member States, could threaten their relative standing in the profession vis a vis younger colleagues.

regulatory competition and Type B regulatory competition.³⁷ Type A competition focuses on “factor mobility” and competition between production locations. Corporate law based on the “seat theory” is one of many components that determine whether a particular jurisdiction is competitive or whether private actors will exercise their “exit” option and choose another location. Type B competition, on the other hand, is premised on the assumption that jurisdictions can market corporate law separately under the incorporation theory. Type B competition thus unbundles corporate law from other legal doctrines and allows jurisdictions to compete with respect to corporate law alone. After *Centros* and *Inspire Art*, this Type B competition has in Europe become more than just a theoretical possibility.

This article goes one step further than Heine’s and Kerber’s analysis and proposes “unbundling” the corporate law product that is offered in Type B competition into two component parts: statutes and adjudication. We then suggest that, for the short term at least, Member States may be more successful in Type B competition for corporate law if they unbundle their product and leave adjudication to private ordering, probably in the form of arbitration. Just as the incorporation theory’s separation of corporate law from other legal rules distinguishes Type B competition from Type A competition, an unbundled corporate law product that separates statutes from adjudication may facilitate Type B competition more effectively in Europe than the bundled “Delaware” product that is common in the United States.

An important difference between competition for bundled and unbundled corporate law is the relative importance of supply and demand for corporate law.³⁸ For the bundled product, the supply side (and in particular the cost of supplying high quality corporate law) is

³⁷ See Klaus Heine and Wolfgang Kerber, *European Corporate Laws, Regulatory Competition and Path Dependence*, 13 *European Journal of Law and Economics* (2002). Klaus Heine’s dissertation, that was the basis for this article, distinguishes between five types of regulatory competition, two of which, Type III and Type IV, are the most relevant for the purposes of this article and are recast in the article as “Type A” and “Type B” competition respectively. Type I is “Yardstick – Competition”, a term first used in A. Shleifer, *A Theory of Yardstick Competition*, in *The Rand Journal of Economics*, Vol. 16 at 319 (1985), and emphasizes the importance of information for functioning of inter-jurisdictional competition. See Heine and Kerber, *supra* at 94. Type II is competition in international markets for goods, which emphasizes increased mobility of goods in international markets, and requires international free trade treaties. Free trade in turn may have limited effects on jurisdictional competition of corporate law. See *id* at 97-101. Type III is factor mobility and competition of production locations under the seat theory - the monopoly of the state is dissolved through “exit” options in choosing another production location/country. See *id* at 101-10. Type IV competition arises out of freedom to choose the jurisdiction of incorporation alone under the incorporation theory - this type of regulatory competition de-bundles corporate law from the jurisdiction of the state, thereby increasing the intensity of competition and the resulting selection process of corporate law. Regulatory competition of Type V requires maximum freedom of contract, deregulation and “private regulation” and emphasizes the importance of party autonomy in creating corporate law. Here, the state is not the entity that drafts and enacts corporate law, and the role of the “producer” of corporate law is shifted to, primarily, private law firms that provide clients with charters to fulfill their specific needs.

³⁸ We are not taking a position here as to whether economic analysis as a normative matter should focus principally on the supply or demand side of the equation. Rather we make a positive observation that in the market for a bundled corporate law product supply side problems are more acute than in a market for unbundled corporate law.

critical. Much of the debate in the United States over regulatory competition thus focuses on the efficiency and predictability of Delaware courts and the substantial investment that Delaware makes in its courts. Any state hoping to compete with Delaware for a bundled product presumably would have to make a substantial initial investment in its own courts. Marginal costs of litigation in Delaware also affect the supply side because each additional user of Delaware corporate law imposes adjudication costs. Delaware recoups these costs, and probably more, when additional users of Delaware law pay franchise taxes and hire Delaware lawyers who assist in adjudication. Another state presumably would only try competing with Delaware if it believed that a similar benefit to its tax collections and lawyers would outweigh the marginal costs of imposing on its courts a greater caseload from persons in other states who use its corporate law. In sum, regulatory competition for a bundled product is only a realistic possibility if relatively high supply side hurdles can be overcome to induce states to enter the market for corporate law.

By contrast, jurisdictions supplying corporate law as an unbundled product would have much lower fixed and marginal costs. Fixed investment would be principally in drafting statutes. Each additional user of the jurisdiction's corporate law would not impose new adjudication costs, and the cost of registering additional corporate charters are relatively insignificant. The supply curve thus would reflect low costs to begin with and little change in costs as the number of charters increased. The jurisdiction's lawyers and other professionals might not benefit as much as they would from the bundled product, but they would still benefit from advising on the jurisdiction's laws and probably would participate in whatever process of adjudication was used to apply those laws. For this unbundled product of statutes only, the key to successful competition would be the demand side: drafting statutes that appeal to large numbers of managers and investors outside the jurisdiction so they will incorporate there.

C. The American Experience with the Bundled Package

Delaware corporate law is a bundled product (choice of law and choice of forum are one and the same). Much emphasis is placed on the quality of Delaware adjudication in debates about the value of incorporating or reincorporating in Delaware, and perhaps even more attention is paid to what Delaware courts do than to acts of the Delaware legislature. Few users of Delaware corporate law seem interested in using Delaware statutes without Delaware judges, and serious experimentation with unbundling the Delaware product has so far not been tried. Alternatives to judicial adjudication of corporate law, such as arbitration, have been talked about,³⁹ but rarely implemented, probably because so much importance is attached to Delaware's system of adjudication.

Furthermore, Delaware courts might be hostile to private ordering that used for Delaware corporations an adjudication apparatus other than Delaware courts.⁴⁰ Such an

³⁹ Professor John Coffee wrote about this possibility in the early 1990's but suggested that it's coming to fruition was unlikely. See text accompanying notes 119-129 *infra*.

⁴⁰ At least when the reverse was tried -- contracting for another jurisdiction's corporate law but using a Delaware charter and Delaware's adjudication system -- Delaware courts disapproved. In *Rosenmiller v. Bordes*, 607 A.2d 465 (Del. Chancery 1991), shareholders of a Delaware corporation entered into a shareholders' agreement specifically providing that the agreement would be governed under the law of New Jersey. The Delaware Court held that under the "internal affairs doctrine" Delaware law nonetheless applied and that under Delaware law the shareholders' agreement was invalid because Delaware law limits voting agreements to a term not exceeding ten years. The arrangement the shareholders sought would have unbundled the operative legal rules (New Jersey's)

arrangement would result in a type of “hybrid” corporation that some American commentators believe is undesirable whether or not legally permissible.⁴¹ Although many disputes under Delaware corporate law do end up being determined by courts in other jurisdictions for a variety of reasons, including federal diversity jurisdiction, this does not mean that an ex-ante agreement requiring adjudication outside of Delaware would be enforceable. In any event, there is little authoritative Delaware case law on this issue,⁴² presumably because there is little interest on the part of managers and investors in unbundling the Delaware corporate law product to begin with.

Views about the quality of Delaware’s bundled corporate law product are mixed, both in scholarly critiques⁴³ and evaluation by persons who actually use the product (both manager and shareholder groups). The relevant literature will not be reviewed here, except to note that not everybody is satisfied with the product Delaware has to offer. Most important, there is concern that Type B competition in the United States over corporate law is not really a competition, but that Delaware instead enjoys a monopoly on charters for corporations headquartered out-of-state regardless of the quality of its corporate law, and that few if any

from the adjudication apparatus (Delaware’s), See also Ribstein, 19 Del. J. Corp. Law 999 at 1022-25 (discussing *Bordes*)

⁴¹ See Erin A. O’Hara and Larry E. Ribstein, From Politics to Efficiency in Choice of Law, 67 U. Chi. L. Rev. 1151, 1206 (2000). For example, the authors hypothesize about a corporation incorporated outside Delaware that nonetheless chooses to be governed under Delaware law. “This would create a sort of ‘platypus’ that is both mammal (a Delaware corporation) and reptile (a corporation under State X law).” Arguments in favor of prohibiting such arrangements are, first, that they could cause confusion, although this obstacle can be overcome by requiring a clear choice of law provision in a charter or shareholders’ agreement. Second, a state arguably has an intellectual property right in its own law, and a right to collect franchise taxes and other benefits, which would be undermined if corporations could use one state’s law but incorporate elsewhere. *Id.* The state whose law was being used thus might object to use of its law in another state of incorporation. This is not, however, a reason why the state of incorporation should prohibit the arrangement, and states do not have an enforceable intellectual property right in their own law (e.g. states cannot prevent their law from being appropriated by other states or by private parties through choice of law provisions). See Larry E. Ribstein and Bruce Kobayashi, Class Action Lawyers as Lawmakers [forthcoming][see web page] (discussing difficulties with extending intellectual property protection to statutes). In the final analysis, O’Hara and Ribstein argue that despite the disadvantages of “platypus” corporations (mostly to the state whose law is being used without receiving benefits in return), such arrangements should be allowed unless prohibited under the law of the state of incorporation. *Id.* at 1207. Using similar reasoning, in a Delaware corporation, the shareholders’ choice of arbitration instead of dispute resolution by Delaware courts should be permitted unless Delaware’s statute specifically provides otherwise. The problem is that Delaware courts might not agree.

⁴² By contrast, Delaware has explicitly approved of arbitration clauses in the context of LLC’s. See text accompanying notes 52-57 *infra*.

⁴³ Compare Romano, *The Genius of American Corporate Law* (1993), Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991) with William Carey, *Federalism and Corporate Law: Reflections on Delaware*, 85 Yale L. Journal 663 (1974).

states compete with Delaware.⁴⁴ Indeed, as Professor Roe suggests,⁴⁵ it is possible that the only serious competitor of Delaware is the federal securities laws, which, most notably in 1933, 1934 and 2002, intervened when protection of shareholders under Delaware law was perceived to be inadequate.

Criticism of Delaware case law is especially acute in certain key areas such as executive compensation⁴⁶ and takeover defenses.⁴⁷ A fair reading of the Delaware General Corporation Law could suggest the results reached in this case law, which in both of these specific areas, and in others, relies heavily on a “business judgment rule” presumption in favor of management. The outcome of Delaware case law could also be efficient.⁴⁸ On the other hand, an adjudicator could also reach different results from reading the same statute. Indeed, with respect to both executive compensation and takeover defenses, serious commentators have argued that an adjudicator in fact should have.⁴⁹

These questions about the quality of Delaware adjudication suggest that it is not a foregone conclusion that the bundled product leads to optimal results. Delaware adjudication may be the best available alternative in the U.S., and indeed no serious state law competition has yet emerged. The Delaware legislature, however, has intervened to correct perceived errors of the Delaware judiciary,⁵⁰ and Congress both has threatened to intervene to reverse perceived laxity of Delaware courts (in the takeover area in the 1980’s) and has in fact intervened (in the 1930’s and again in the Sarbanes-Oxley Act of 2002).⁵¹ In view of the

⁴⁴ See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 *Stan. L. Rev.* 679 (2002); Lucian A. Bebchuk, Alma Cohen and Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 *Cal. L. Rev.* 1775 (2002) (no).

⁴⁵ See Mark J. Roe, *Delaware’s Competition*, 117 *Harv. L. Rev.* 588 (2003).

⁴⁶ Lucian A. Bebchuk, Jesse M. Fried, and David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 *U. Chi. L. Rev.* 751 (2002).

⁴⁷ See Lucian A. Bebchuk & Allan Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 *Va. L. Rev.* 111 (2001) (criticizing Delaware’s deference to takeover defenses and recommending that there be a federal statute similar to the London City Code strict neutrality rule that corporations can opt into).

⁴⁸ See Romano, Easterbrook & Fischel *supra*. Ironically, some authors who generally promote the efficiency of Delaware corporate law have been among the most ardent critics of Delaware case law in at least one key area, deference to management on takeover defenses.

⁴⁹ See Bebchuk et al. and Bebchuk & Ferrell, notes 46 and 47 *supra*.

⁵⁰ See e.g., *Del. G. Corp. L.* 102(b)(7) (allowing corporate charters to opt out of suits against directors for money damages for breach of duty of care) responding to *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985) (holding directors liable for lack of due care in valuing company prior to approving its sale).

⁵¹ See Roe *supra* note 45. The Sarbanes-Oxley Act addresses, among other aspects of substantive corporate law, director oversight of management for possible wrongdoing. This issue was addressed by the Delaware Supreme Court in *Graham v. Allis Chalmers*, 188 A.2d 125 (Del. 1963) (discussing directors’ duty to respond to affirmative signs of wrongdoing), and over thirty years later by the Delaware Court of Chancery, in dicta in *In Re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (qualifying the holding in *Graham* and suggesting that in some circumstances directors are required to exercise supervisory powers to monitor for wrongdoing). Although *Caremark* suggested that Delaware was moving toward imposing stricter standards, Congress, after the collapse of Enron and Worldcom, did not believe state law adjudication in this area was moving fast enough to merit continued abstention from federal intervention in corporate governance.

higher costs in Europe of combining corporate law statutes with adjudication, discussed in Section D below, Europeans should perhaps be more reticent about the view that adjudication by the state of incorporation is the only alternative. The quality of corporate law adjudication by the courts of a Member State may not reach the quality of adjudication in Delaware, whereas the costs of a bundled product to a European jurisdiction and to users of its corporate law may be substantially higher than they are in Delaware.

Finally, it is noteworthy that Delaware itself acknowledges the utility of unbundling statutes from adjudication, although not in its corporate law. In its LLC statute, Delaware specifically allows members or managers to agree in the LLC agreement, or in another writing, for arbitration of claims under the agreement.⁵² In *Elf Atochem North America, Inc. v. Cyrus A. Jaffari and Malek LLC*,⁵³ the Delaware Supreme Court interpreted this provision broadly, emphasizing that freedom of contract is an essential element of the Delaware LLC statute.⁵⁴ In at least two other cases, *Karish v. SI Int'l Inc.*⁵⁵ and *Child Care of Irvine, LLC v. Facchina*,⁵⁶ Delaware courts have also either enforced, or indicated that they would enforce, arbitration clauses in the context of LLCs. It is true that some states have taken a more restrictive view of arbitration agreements in LLC agreements,⁵⁷ and that Delaware's policy of enforcing arbitration agreements in LLCs does not necessarily extend to Delaware corporate law, a context in which, as already noted, arbitration provisions apparently have not been tried.⁵⁸ Nonetheless, in the LLC context, not only does Delaware permit arbitration of disputes, but some members and managers are in fact choosing this unbundled version of

⁵² See 6 Del. C. Section 18-109(d), which provides: "In a written limited liability company agreement or other writing, a manager or member may consent to be subject to the nonexclusive jurisdiction of the courts of, or arbitration in, a specified jurisdiction, or the exclusive jurisdiction of the courts of the State of Delaware, or the exclusivity of arbitration in a specified jurisdiction or the State of Delaware . . ."

⁵³ 727 A.2d 286 (1999) (holding that Delaware's LLC statute, which permitted members and managers to agree to nonexclusive jurisdiction in a forum other than Delaware also allowed the parties to contract for exclusive jurisdiction in another forum, and that this agreement was enforceable even if the LLC itself was not a party to the LLC Agreement).

⁵⁴ "The Act's basic approach is to permit partners to have the broadest possible discretion in drafting their partnership agreements. . . ." *Id.* at 291, quoting Martin I. Lubaroff & Paul Altman, Delaware Limited Partnerships, Section 1.2 (1999), and stating that this same "observation relating to limited partnerships applies as well to limited liability companies."

⁵⁵ C.A. No. 19501 (Del. Ch. June 24, 2002) (enforcing an LLC agreement clause providing for arbitration of disputes "arising out of or relating to" the LLC agreement, in a suit concerning repurchase of a member-manager's shares, even where the management agreement did not provide for arbitration).

⁵⁶ C.A. No. 16227 (Del. Ch., July 15, 1998) (in a dispute over removal of a manager of an LLC, there was confusion about which of two versions was the rightful LLC agreement, but the Chancery Court observed that both of the versions required arbitration of the dispute and thus encouraged the parties to arbitrate rather than litigate further as to which version was the rightful LLC agreement).

⁵⁷ See *Bubbles & Bleach, LLC v. Becker*, No. 97 C 1320, 1997 WL 285938 (N.D. Ill. May 23, 1997) (refusing to enforce an arbitration clause unless the LLC itself was a party). See Leigh A. Bacon, Note: "Freedom of" or "freedom From"? The Enforceability of Contracts and the Integrity of the LLC, 50 Duke L.J. 1087 (2001) (discussing the two contrasting opinions in *Elf* and *Bubbles & Bleach*).

⁵⁸ See text accompanying note 39 *supra*.

Delaware's LLC law. It is also noteworthy that the interest group within Delaware that seemingly might oppose arbitration, Delaware lawyers, has not prevailed upon the Delaware legislature or courts to restrict arbitration in the LLC context, and may not even be opposed to it.⁵⁹

Indeed, if unbundling of corporate law is successful for Europe and/or if Delaware's own experiment with unbundling in its LLC statute proves successful, Delaware could decide to extend this approach to corporate law. Alternatively, another state could compete with Delaware by offering a corporation law similar to Delaware's that could then be interpreted by professional arbitrators instead of by local judges.⁶⁰ Over time, the arbitrators might render decisions that are as predictable as Delaware's but that are substantively different and thus superior from the vantage point of at least some corporate constituents. Although the prospect for unbundled Type B regulatory competition in the United States is not the subject of this article, this possibility is still worth mentioning.

D. Barriers to Entry for Member States Offering Bundled Corporate Law

Under the "Delaware model" discussed above, a jurisdiction exports both its corporate law (statutes) and adjudication of corporate disputes (courts) as a single bundled package to managers and investors in other jurisdictions. This exporting jurisdiction may or may not have much competition from other jurisdictions.

Some American scholars claim high barriers to entry keep potential competitors out of U.S. regulatory competition, giving Delaware a virtual monopoly.⁶¹ Although the height of barriers to entry into the U.S. market for corporate law is debatable, these barriers are at least significant. The first barrier is path dependence.⁶² Existing corporations are unlikely to switch their state of incorporation even if the corporate law of another jurisdiction might be more advantageous. Lawyers also are path dependent when, being familiar with their own jurisdiction's corporate law and that of Delaware, they are reluctant to recommend anything other than these two alternatives. Second, designing a corporate law that balances the interests of managers and investors is difficult, and designing and staffing a good adjudication system is expensive. The qualitative threshold for both statutes and adjudication, and the investment required to meet this threshold, is probably higher if a jurisdiction seeks to attract corporate charters from other jurisdictions than if the only objective is convincing a reasonable percentage of corporations having their principal place of business in the jurisdiction to incorporate there. Third, initial investment required for a jurisdiction to have a

⁵⁹ As two noted commentators observe, "[l]awyers might favor even enforcement of a contract that does not choose their state as a forum as long as it selects their state's law. Regardless of the forum, experts in Delaware law are more likely to be chosen to represent the parties if the contract applies Delaware law. Consistent with this objective, the Delaware Supreme Court [upheld arbitration] in *Elf Atochem*" Erin A. O'Hara and Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. Chi. L. Rev. 1151, 1229 (2000).

⁶⁰ The possibility of arbitrating corporate law disputes in the U.S. has already been raised by Professor John Coffee, see accompanying notes 119-129 *infra*, and for several reasons, many of which are discussed in his article, has not yet been tried. A successful European experiment with arbitration, however, might lead Americans to reconsider the relative merits of bundled and unbundled corporate law. On the other hand, there are unique obstacles to unbundling corporate law in the U.S. which are not fully discussed in this article and that would have to be addressed by any state hoping to compete with Delaware on this basis.

⁶¹ See notes 44-49 *supra*.

⁶² See Roe, *supra* note 33.

corporate law “superior” to Delaware’s would not be recouped quickly because it would take time to induce managers and investors to incorporate in the jurisdiction. Mechanics of state budgets and short time horizons of politicians further discourage investment in competing with Delaware. Finally, competition for out-of-state corporate charters could affect constituents of locally based corporations (such as management and labor) whose interests conflict with the interests of investors. These constituents may dominate the local political process, at least in states with many locally based corporations. This is one reason why some scholars doubt that New York, California, or other large states could effectively compete with Delaware in designing a law that is attractive to capital markets, and a reason why Delaware, as a relatively small state, has an advantage.⁶³

At least some of these barriers to entry into the market for corporate law would also exist in Europe, perhaps even more so than in the United States. Path dependence is an important one, at least in Member States whose legal, cultural and economic systems resist change.⁶⁴ Initial expenditures on drafting statutes and designing adjudication systems that appeal to managers and investors in other Member States also may be hard to justify when many Member States have severe budget deficits. Political obstacles to investor friendly corporate law also exist in Europe, particularly in larger Member States. For example, Germany’s corporate law accommodates interests of non-shareholder constituencies, particularly workers, who reside within Germany. Even if *Inspire Art* poses some threat to the German system of codetermination because private actors can avoid German law by incorporating elsewhere within the EU, this does not mean that Germany will rush to prevent emigration of corporate charters by abandoning deference to labor and other local interests in its corporation law. There may be piecemeal changes designed to make German corporations more attractive to capital markets, perhaps even changes to codetermination,⁶⁵ but wholesale revision of German corporate law in order to appeal to non Germans is in the short term unlikely. The same may be true for some other large Member States, including France and Italy.

In fact, only one large Member State, the U.K. so far seems to be successfully marketing corporate charters to private actors in other Member States after *Inspire Art*. Most of these charters have so far been for smaller enterprises, and the attraction of U.K. law for

⁶³ See Jonathan R. Macey and Geoffrey P. Miller, Toward an Interest Group Theory of Delaware Corporate Law, 65 Texas L. Rev. 469, 490 (1987) (“Because the physical assets of most large Delaware corporations are located in other states, Delaware lawmakers ordinarily are not subject to pressures from unions, environmental groups, local communities, or other special interests associated with the corporation’s physical plant or assets.”). See also Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J. L. Econ. and Org., 225 (1985) (observing that small states such as New Jersey and then Delaware prevailed in the market for corporate charters).

⁶⁴ See text accompanying notes 33-34 supra (discussing path dependence). In keeping with the path dependent outlook of European managers and investors, and of the persons who advise them, it does not appear so far that there is much interest in the latest new form of organization, the European Company or SE..

⁶⁵ See Christian Kirchner, Grundstruktur eines neuen institutionellen Designs für die Mitbestimmung von Arbeitnehmern im Unternehmen, Beitrag für die Tagung “Corporate Governance und Modernisierung der Mitbestimmung”, December 12, 2003 (manuscript on file with authors) (discussing proposal for establishment of separate employee advisory boards in place of employee representative membership on supervisory boards)..

large publicly held enterprises headquartered outside the U.K. has not yet been tested.⁶⁶ Many of the individuals standing behind smaller enterprises choosing to incorporate in the UK also may not think about the possibility that a dispute will ever arise in their corporation. They also may expect that, if a dispute does arise, it will be resolved by judges in the jurisdiction where the corporation does its business rather than by courts in the U.K. To the extent adjudication over U.K. corporate law is expected to be carried out somewhere other than the U.K. the U.K. has not exported a bundled product at all. Users of U.K corporate law who expect adjudication elsewhere, like users of Delaware’s LLC statute who choose adjudication outside of Delaware,⁶⁷ are apparently demonstrating a preference for an unbundled package.⁶⁸

Other barriers to entry into the market for a bundled corporate law product could be even higher in Europe than they are in the U.S., and some of these barriers are discussed more extensively below. Because of these barriers to entry, it may be easier for Member States to unbundle their version of the “Delaware product” and export corporate statutes without adjudication by national courts.

I. Transaction Costs, Path Dependencies and Rule Switching Costs

1. Language Barriers

Language barriers could make it difficult for Member States to offer a bundled package of statutes plus adjudication if their courts do not conduct proceedings in English, the only language widely understood throughout the EU. Statutes can with relative ease be translated so they are understood by investors, managers, and lawyers in other jurisdictions. Case law could also be translated, although it becomes increasingly voluminous over time. Conducting judicial proceedings through interpreters, however, is cumbersome and confusing, and also creates a perceived bias in favor of litigants and lawyers who are fluent in the language of the proceedings. Many investors, managers, and lawyers simply will not accept the transaction costs associated with reincorporating if it required moving from courts that conduct proceedings in a familiar language to courts that conduct proceedings in a foreign language, particularly one other than English.

From the Member State’s perspective, corporate law statutes do not have to be drafted in English so long as there are “official” translations into English, and perhaps other languages. Marketing a bundled package that includes adjudication, however, probably requires that adjudication be conducted in English. Member States unwilling to incur the rule switching costs involved with using English in judicial proceedings could be precluded from marketing their corporate charters in other Member States that do not speak the same language. Most European judicial proceedings, however, are conducted in the native language of each Member State. It thus is not surprising that, so far, the U.K. seems to be

⁶⁶ See text accompanying note 13 supra, discussing limited data available from filings with Companies House in the U.K.

⁶⁷ See text accompanying notes 52-57 supra, discussing provision in Delaware’s LLC statute allowing LLC agreements to provide for arbitration or adjudication in another jurisdiction.

⁶⁸ See Section EII below, discussing difficulties that could arise from adjudication of U.K. law in another Member State such as Germany. These difficulties might persuade users of U.K. corporate law to go back to U.K. courts or to explore other alternatives for unbundling such as arbitration, discussed in Section EIII below.

alone among Member States in attracting a significant number of corporate charters from outside its borders when incorporation theory became viable after *Centros* and *Inspire Art*.⁶⁹

2. *Differences Between Common Law and Civil Law Approaches*

Experience with regulatory competition under the incorporation theory has thus far been in common law jurisdictions such as the U.S., the U.K and Israel,⁷⁰ and not in civil law jurisdictions, few of which used incorporation theory prior to *Centros* and *Inspire Art*.⁷¹ This may give common law jurisdictions an advantage in making their statutes, and particularly their courts, more attractive to corporations having a principal place of business elsewhere. Indeed, the very few examples where incorporation theory was used within Europe thus far (including in both *Centros* and *Inspire Art*) involved corporations having their seat in civil law jurisdictions that incorporated in a common law jurisdiction, the U.K. Few disputes have arisen, however, over the governance of these new U.K. corporations and when disputes do arise, it has yet to be seen how investors and managers in civil law countries will react to having their disputes resolved under common law principles in U.K. courts.

Differences between common law and civil law are most likely to create barriers to entry for a civil law Member State offering a bundled package of statutory law and adjudication to managers and investors in common law states. Civil law systems have been criticized generally for offering less protection than common law jurisdictions to minority shareholders from exploitation by controlling shareholders.⁷² Civil law systems are also believed to be less flexible because civil law courts have less discretion. Whether or not these criticisms are valid, if investors believe civil law systems disadvantage minority shareholders, are less flexible or otherwise disadvantageous, a civil law corporate charter is not likely to appeal to public investors who are used to a common law system.

The weak link in the bundled package offered by a civil law jurisdiction is thus likely to be its system of adjudication rather its statute. To the extent the statute is more detailed than statutes in common law jurisdictions, it may comparatively be more attractive to investors and managers who value predictability. This may not, however, make up for the fact that judicial enforcement could be haphazard, and that judicial precedent could be given less weight in future decisions, meaning there could be no valuable body of case law that can

⁶⁹ Specific ways in which unbundling corporate law from adjudication can overcome language barriers, and the other barriers mentioned in this Section D, are addressed in Section E below.

⁷⁰ For discussion of how Israeli companies utilize their option under incorporation theory to incorporate in Delaware, see Edward B Rock, *Coming to America?*, Venture Capital, Corporate Identity and U.S. Securities Law [manuscript on file].

⁷¹ Louisiana recognizes Delaware corporations in the United States, showing that civil law systems can accommodate incorporation theory. Louisiana, however, has, not been a serious contender for exporting its corporate law to the other states, all of which are common law jurisdictions, although the same is true for these other states themselves, which have declined to compete with Delaware in the market for corporate charters.

⁷² See Raphael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, *Legal Determinants of External Finance*, 52 *Journal of Finance* 1131 (1997).

be used to predict outcomes.⁷³ Although some civil law jurisdictions have a relatively efficient adjudication system and give significant weight to precedent in corporate law, much of the value of their corporate law may still be attributable to statutes rather than to courts. In other civil law jurisdictions, the adjudication component may be worth quite little, or may detract from the value of the underlying statute.

It is true that different aspects of corporate law such as statutes and adjudication are interdependent, and that many civil law systems achieve a balance between substantive law and remedies that is reasonably attractive to domestic users of their law.⁷⁴ This same balance, however, may not be attractive to managers and investors in other Member States who are used to a different adjudication system and who, even if they are attracted to a jurisdiction's statutory scheme, may not like its adjudication system.⁷⁵ Problems with a civil law jurisdiction's underlying statute – for example if it gives inadequate protection for minority shareholders – are also more easily fixed than problems with a judiciary that fails to apply the statute in a predictable and uniform manner. A civil law jurisdiction that wants to attract managers and investors from other jurisdictions to its corporate law thus might best focus on adjusting its statutes and allowing users who do not like its adjudication system to opt into another forum.

Finally, even European common law jurisdictions are not necessarily similar to the American “Delaware” model that has resulted in a large body of interpretive case law. The “common law” English system, for example, is gravitating toward a civil law approach, giving significantly more weight to statutes than to judicial interpretation of those statutes. The value of the “bundled package” of statutory law and adjudication provided by the state of incorporation even in a common law jurisdiction thus may not greatly exceed the value of the statutory law standing alone.

3. *Procedural Differences*

Delaware procedural law is not that different from the procedural law of other states. Although litigants often retain Delaware co-counsel for cases in Delaware courts, out-of-state

⁷³We are not positing that weak adjudication systems and lack of precedent are characteristic of all civil law jurisdictions. Some, such as Germany, have detailed statutes and reasonably strong adjudication systems, although these jurisdictions' corporate law may be unattractive to outside investors and managers for other reasons. See note 11 *supra*.

⁷⁴ See Reinier Kraakman, et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004) (discussing how various legal systems address tradeoffs among three types of agency problems: managers vis-a-vis shareholders; controlling shareholders vis-a-vis minority shareholders, and the firm itself vis-a-vis other constituencies such as creditors and employees). See *Id.* at 216 (discussing functional and comparative approach to corporate law that is wholistic in recognizing that, rather than dealing with these agency problems in isolation, legal tradeoffs are involved in minimizing costs across all three agency problems).

⁷⁵ Managers and investors who incorporate in a civil law jurisdiction but opt out of its adjudication system obtain a different balance between statutory structure and remedies than that given to managers and investors who stay with the jurisdiction's adjudication system. This, however, may be precisely the point, because managers and investors in other jurisdictions may prefer that the civil law jurisdiction's statutes be combined with a different adjudication system. The fact that a jurisdiction's statutes and adjudication systems are interdependent, does not mean that the jurisdiction's adjudication system is the only workable complement to its statutory scheme.

counsel usually participates to a large extent in drafting briefs, trying the case (*pro hac vice*) in the Delaware court, and in other aspects of the case. Out of state lawyers, particularly in large cities such as New York or Chicago, are generally familiar with Delaware procedural law. Law students all over the United States learn substantive Delaware law and some procedural Delaware law in their corporate law courses, usually more than they learn the law of their own jurisdiction.

Not so in Europe. Procedural differences are greater between courts of many Member States than between courts of different states in the U.S. Path dependence in European legal education produces lawyers who are familiar with procedures in their own courts, but unfamiliar with procedures in courts of other Member States. European corporations thus depend upon lawyers in their jurisdiction of incorporation more than American corporations depend upon local counsel in Delaware, meaning there would be a serious competitive threat to lawyers in a European corporation's principal place of business if a client chooses to incorporate elsewhere. Unlike New York and California lawyers who routinely advise clients to incorporate in Delaware, and who are eager to help clients litigate in Delaware courts, European lawyers thus may advise clients to incorporate at home simply because these lawyers do not want to deal with the courts and lawyers of another Member State. Lawyers in a corporation's principal place of business, however, might be more willing to consider advising incorporation in a Member State offering an unbundled package of statutes only, particularly if the procedures of the chosen forum for litigating disputes under these statutes, whether a court or arbitration panel, were familiar to them.

4. *Costs of Building a Judicial System for Export*

Rule switching costs for a European jurisdiction competing for corporate charters from outside its borders would almost certainly be higher for a bundled than for an unbundled package of corporate law. Drafting and enacting a suitable corporate statute would be relatively inexpensive (the Member State could simply copy large parts of the statutes of another Member State, a Model Code of corporate law or even a non-EU jurisdiction such as Delaware). Once the statute is enacted, marginal costs when investors and managers in other Member States use it are minimal (each additional user that chooses to incorporate in a Member State imposes very low costs on that state). Adjudication, however, is different. No Member State currently has courts that specialize in corporate law as does the Delaware Court of Chancery. Establishing such specialized courts, or raising the level of expertise of existing courts, would be expensive for most Member States, and marginal costs would be high because the more litigants use these courts, the more costs of adjudication are imposed on the Member State. Large case loads brought on by foreign users of the Member State's corporate law could result in delays that irritate domestic users who in turn might demand that the Member State seek to attract fewer rather than more corporate charters from other Member States. Additional rule switching costs for a Member State offering a bundled corporate law package might include changes to procedural rules that corporations headquartered in other Member States consider arcane or cumbersome. Finally, there is the likely prospect that hearings would have to be conducted in English or that translation would be required.

The worrisome question is how the potentially expensive package of corporate statutes plus adjudication would be paid for. Two of the most often mentioned sources for financing Delaware's bundled package in the United States, franchise taxes and legal fees for Delaware counsel, unfortunately might not be as lucrative for a European Member State. Theoretically, franchise taxes on corporate charters (which in Delaware vary with capitalization), could be charged by an EU Member State, but they might have to be substantially higher than the taxes in Delaware to pay for the start up costs of setting up a specialized corporate law court system. Furthermore, a franchise tax system could be difficult to implement in a jurisdiction that has traditionally taxed corporations principally based on

revenues generated from corporate operations within its borders (a tax system that fits nicely with the seat theory of incorporation). There might be stiff political resistance to a franchise tax from companies already incorporated in the Member State that now get both their corporate statute and adjudication without paying a franchise tax. At least the larger European Member States that already have a substantial number of corporations within their borders using their corporate law, are likely to confront such resistance to franchise taxes. Furthermore, a franchise tax might confront legal difficulties in the various Member States or on the E.U. level in addition to these obvious political difficulties.

The other principal payoff for Delaware from exporting its corporate law as a bundled product is the value of services exported by Delaware lawyers. Corporate law cases in the United States often involve thousands of lawyer hours and millions of dollars in lawyers' fees, much of it in Delaware. There is incomplete information about whether the same would be true in Europe. The increase in the volume of legal services in a Member State due to its attracting corporate charters from elsewhere might be lower than in the highly litigious US, and might not justify the more predictable ex-ante cost to the Member State of making the necessary adjustments to its adjudication system so it could more easily be used by investors and managers residing elsewhere.

Unbundling statutes from adjudication by contrast would give Member States an opportunity to avoid these problems by offering a product which has a low marginal cost. Corporate franchise taxes charged by a unbundling Member State could be correspondingly lower, thus encouraging more business to incorporate there. Lawyers in the Member State would still probably retain a role in advising corporations on litigation under that Member State's corporate statute (particularly if the chosen forum were arbitration rather than some other Member State's national courts). At a minimum, unbundling allows Member States to "test the waters" by offering their corporate law to managers and investors in other Member States before making an expensive investment in adjudication. With the unbundled product, more member states thus might participate in regulatory competition over corporate law, which would speed up the learning process⁷⁶ and likely result in better substantive corporate law.

II. Bounded Rationality and Incomplete Information

1. *Bounded Rationality and Incomplete Information About Judicial Bias*

Investors' and managers' fear of judicial bias in another Member State could discourage them from taking advantage of the opportunity to incorporate outside the Member State in which they reside. First, investors' or managers' bounded rationality could cause them to fear judicial bias even when there is none. Second, judges are boundedly rational and could, knowingly or unknowingly, allow irrational political or cultural biases to affect their decisions. Third, judicial bias could be rational if judges gain personally or professionally by favoring a litigant of one nationality over a litigant of another.

Real or perceived judicial bias comes in many forms. Judges could be biased in favor of litigants domiciled in their own country. This is yet one more reason large Member States

⁷⁶ New Institutional Economics recognizes that imperfect information and bounded rationality affect rule makers, and the importance of overcoming these limitations through a learning process of experimentation with different rules and observing the results of this experimentation. See note 14 *supra*. Presumably, the more Member States compete with respect to corporate law, the more experimentation there will be, and the more effective the learning process will be.

where many likely litigants reside might have difficulty attracting corporate charters from other Member States. Judges could also be biased against litigants because of their nationality. Europe's major conflicts ended only sixty years ago and other more regional conflicts remain (Northern Ireland, Cyprus, Gibraltar, etc.). Some smaller EU Member States such as the Netherlands and Ireland, which might for other reasons be favored candidates for becoming the "Delaware of Europe", have suffered in conflicts with their larger neighbors. In Europe as in the U.S., past and present political tensions leave fertile ground for bounded rationality and incomplete information about judicial bias to intrude.⁷⁷

When investors and managers perceive bias on the part of judges in another Member State, a two-fold problem of bounded rationality and incomplete information comes into play. One group of actors (investors and managers) is uncertain how another group of actors (judges) will respond to a given situation, and all actors may assume the worst. Risk premiums charged by actors often reflect both bounded rationality and incomplete information, and managers and investors thus may put a higher price on a decision to incorporate in another Member State. Higher costs of recruiting, retaining and insuring managers or higher costs of raising capital could follow. These risk premiums in turn may be sufficiently high to discourage a "transaction" that otherwise would take place (here the decision to incorporate in a Member State other than the corporation's principal place of business). If on the other hand, statutes are unbundled from adjudication, this problem largely disappears because statutes are at least facially neutral (statutes that discriminate for or against investors and managers who are nationals of another Member State presumably would violate the EU treaty, as pointed out in *Centros* and *Inspire Art*).

For example, in what circumstances would an investor domiciled in Member State A take a 30% stake in a company incorporated in Member State B that is 70% controlled by investors also domiciled in Member State B, if in addition to Member State B's corporate law, there is the prospect of adjudication of a minority shareholder oppression case by a court of Member State B? It is true that under the "seat theory" investors from Member State A have no choice but to accept Member State B's corporate law if they want to invest in a corporation having its principal place of business in Member State B, and it is also true that many European investors have accepted this tradeoff in the past. It also is probably true that investors charge a risk premium for accepting adjudication in foreign courts. The question relevant to the present analysis is, however, whether Member State A investors in a company *already having its principal place of business in Member State A*, once they are allowed to choose which Member State's laws apply under *Centros* and *Inspire Art*, would voluntarily subject themselves to adjudication by courts in Member State B even if they prefer Member State B's corporate law, and if so what risk premium they would charge for doing so. In circumstances where real or perceived judicial bias may raise risk premiums assessed by foreign investors, and perhaps affect decisions about where to incorporate, it may be easier for Member State B to unbundle its corporate law product and export its statutes but not its courts.

⁷⁷ The United States went through similar experiences, only earlier. When Delaware started its ascent in the U.S. corporate law "race" over seventy years ago, animosity still lingered from the Civil War. It is perhaps not a coincidence that Delaware was a northern State, but had many southern sympathizers and is close to the Mason-Dixon Line. It is not certain that New Hampshire, Rhode Island or South Carolina, even if they had optimal statutes and courts, could have, as successfully as Delaware, convinced both southern and northern investors and managers that judges would not be biased against them.

2. *Incomplete Information About How Judges will Resolve Conflict of Laws Problems*

Conflict of laws problems are relatively easy to manage in the context of Type A regulatory competition under the “seat theory.” A single jurisdiction’s laws apply to a wide range of issues, whether corporate law, creditor protection law or labour law, and these laws are usually designed to complement rather than conflict with one another. If it is clear which jurisdiction is the “seat” primarily responsible for providing the entire bundle of law, it matters less which particular set of legal doctrines out of this bundle applies to a particular problem. Conflict of laws problems usually arise in isolated instances such when a factory is set up in another jurisdiction having labour law that is different from that in the corporation’s principal place of business.

Conflict of laws problems, however, become more complex, and are a much greater threat to the entire system of regulatory competition, once a jurisdiction markets its corporate law as a separate product in Type B regulatory competition. It has to be clear which rules apply when corporate law rules conflict with rules in the corporation’s principal place of business or with rules in other places where the corporation does business. The answer to such questions, and perhaps the success of Europe’s experiment with Type B regulatory competition, will turn largely on whether there is a clear understanding of what is corporate law and what is not.

Capital market law (including in Europe much of the law governing tender offers for public companies⁷⁸), for example, is not part of corporate law. *Centros* and *Inspire Art* thus probably do not affect capital market law, which will remain that of the Member State where a securities transaction occurs (both a tender offer itself and defenses against the offer thus would be governed by the Member State where the target corporation lists its securities, usually its principal place of business⁷⁹). The fact that capital market law generally comes from the jurisdiction where capital market transactions take place, not from the chosen state of incorporation, however, does not necessarily stop a state of incorporation from enacting corporate law provisions that conflict with the capital market law of another Member State. Such “overreaching” by the state of incorporation is perhaps more likely when dividing lines between capital market law and corporate law are not entirely clear (particularly if other important jurisdictions such as the U.S. draw those lines differently).⁸⁰ For example the U.K. Parliament could change U.K. corporate law to make directors subject to shareholder

⁷⁸In the U.S., by contrast, the law governing defenses against tender offers is largely, although not entirely, the corporate law of the state of incorporation.

⁷⁹It is conceivable that tender offers should be governed under the law of the Member State in which the tendering shareholder resides on the theory that the securities transaction takes place in that Member State. For large corporations having shareholders in several Member States, however, this approach would be cumbersome if there was inconsistent regulation. In any event, applicable capital market law has generally been viewed to be that where the corporation has its “seat”, which is usually the same place as where the corporation lists its securities (e.g. the London City Code applies to corporations listed on the London Stock Exchange). The *Centros* and *Inspire Art* decisions are not likely to affect this.

⁸⁰As pointed out above, the law governing takeover defenses, while viewed as capital market law in Europe, is part of state corporate law in the United States. A Member of State that wanted to regulate takeover defenses in its corporate law might take the position that the U.S. approach is preferable. Even without an act of the legislature, a Member State of incorporation’s judges might be tempted to adopt such an approach and develop a jurisprudence on takeover defenses analogous to that of Delaware.

derivative suits for implementing takeover defenses without prior permission from shareholders, and then specifically provide that this provision was binding on all U.K. corporations, including a U.K. corporation having its principal offices, and most of its shares trading, in Germany.⁸¹ Such a law would conflict with German capital market law, which gives directors substantially more discretion in implementing takeover defenses, and U.K. judges and German judges might react differently to the task of resolving this conflict.⁸²

The dividing line between corporate law and some other areas of law can be even more muddled. Corporate law in some Member States is interwoven with labor law, creditor protection law and other legal doctrines which in incorporation theory jurisdictions such as the U.S. intersect less with corporate law. Minimum capital requirements, for example, while abandoned for the most part in the U.S., are still used, although ineffectively, for creditor protection in Europe.⁸³ Indeed, incorporation in the U.K. in both the *Centros* and *Inspire Art* cases was intended to avoid minimum capital requirements in the corporation's principal place of business. Despite these ECJ holdings, however, a Member State could still seek to use minimal capital requirements to protect creditors within its borders. Denmark, for example, might forbid any corporation (foreign or domestic) from doing business in Denmark if it did not have a certain minimum capital (or perhaps a certain net worth) even though the corporate law of the U.K. does not impose such a requirement. The question then arises as to whether such a measure also conflicts with the freedom of establishment as interpreted in

⁸¹ Under this scenario, the U.K. corporate law would incorporate the "strict neutrality rule" of U.K. capital market law (the London City Code), a rule rejected in the far more permissive takeover provisions that in 2002 were added to Germany's capital market law. See Christian Kirchner and Richard W. Painter, *The New German Corporate Takeover Law: Comparison with Delaware and Recommendations for Reform*, 50 AMERICAN JOURNAL OF COMPARATIVE LAW 201 (2002). U.K. and German law would be invalid if they conflicted with an EU directive, including the EU's Directive on corporate takeovers, but in this instance there is no such conflict because the takeover directive, as finally adopted in 2004, allows both the U.K. and Germany to retain their rules on takeover defenses. See Directive 2004/25/EC of the European Parliament and of the Council on Takeover Bids, Official Journal L 142, 30/04/2004 at 0012-0024 (setting forth a version of the strict neutrality rule in Article 9(2) but stating in Article 12 that "Member States may reserve the right not to require companies as referred to in Article 1(1) which have their registered offices within their territories to apply Article 9(2) . . . " and that Member States may also exempt companies "if they become the subject of an offer launched by a company which does not apply the same Articles as they do [e.g. by a Delaware company which is not bound by a strict neutrality rule]"). The legal question would be whether a company incorporated in the U.K. but with its shares traded in Germany and its principal offices in Germany, would be subject to the more lax German capital market rule on takeover defenses, and whether this would still be the case if the U.K. were to adopt the strict neutrality rule as part of its corporate law as well as its capital market law.

⁸² German capital market law now allows managers to implement takeover defenses proposed by the management board and approved by the shareholders or by the supervisory board ("Aufsichtsrat"). See Wertpapieruebnahmegesetz, Section 33. It is not obvious how this provision would be implemented in the case of a company incorporated in the U.K. and not having a two-tier board structure, but with its principal offices and shares traded in Germany. Approval of takeover defenses by a majority of the company's independent directors might be deemed equivalent to approval by the majority of a German supervisory board.

⁸³ But see Peter Mankowski, *supra* note 12 (pointing out that after the *Inspire Art* decision, France lowered its minimum capital requirement for its SARL to one Euro).

Centros and *Inspire Art*. Probably not, so long as the Danish statute did not discriminate against foreign corporations, but this answer suggests that Member States can avoid at least part of the result in *Centros* and *Inspire Art* by recharacterizing what used to be corporate law as creditor protection law.⁸⁴ Which other rules, now part of the corporate law of Member States, could be recharacterized as creditor protection law, labor law or some other body of law in order to narrow the true impact of *Centros* and *Inspire Art* (and in particular the potential impact of those cases on Germany's codetermination system)? This recharacterization of law could be done by legislatures, but judges acting alone also could hold that, for whatever public policy reason, a particular provision of corporate or other law in a corporation's principal place of business takes precedence over the corporate law of the Member State of incorporation. Judges in the Member State of incorporation might respond by holding that their law instead takes precedence, and the issue might have to be resolved by a petition to the ECJ.

What does this problem have to do with unbundling statutes from adjudication? Quite a lot if judges in the Member State of incorporation could make conflict of laws problems worse. To the extent judges are biased in favour of expansively interpreting the reach of their own Member State's corporate law, corporations might unexpectedly be bound by the Member State of incorporation's rules governing subject matter such as takeover defenses, creditor protection, employee protection or accounting rules even though the corporation believed this subject matter was outside the reach of corporate law. Unbundling corporate law statutes from adjudication and assigning conflict of laws problems to a more "neutral" decision maker might mean more measured application of corporate law, assuming the decision maker is more sensitive than national judges would be to conflicts with the law in a corporation's principal place of business. If investors and managers consider such conflicts undesirable, along with the legal uncertainties that come with them, adjudication of corporate law outside the Member State of incorporation may be a better alternative.⁸⁵

Finally, it would be enormously helpful if there were a uniform approach among European adjudicators when conflicts do arise between corporate law and laws in a corporation's principal place of business (e.g. a uniform law in the EU governing conflict of laws). Courts in the various Member States, ruling on the reach of their own corporate law, might use different approaches to conflict of laws and come to different conclusions. A single body of arbitrators, affiliated through an association, is theoretically at least in a better position to develop a more systematic and consistent approach to conflict of laws problems unique to the incorporation theory. At least in the early stages of Type B regulatory competition in Europe, adjudication of conflict of laws problems by arbitrators could promote consistency and even create a road map for later adjudication of these same problems by national courts.

Conflict of laws problems admittedly could again emerge when parties seek enforcement of a judgment. A state other than the Member State of incorporation could, for

⁸⁴ Alternatively, it could be argued that creditor protection aspects of the corporate law of the Member State where the corporation has its principal place of business apply rather than the law of the state of incorporation. See Altmeyden, *supra* note 19. Cf. Sandrock, *supra* note 19.

⁸⁵ Adjudication outside the Member State of incorporation of course does not stop overreaching by courts in the Member State where the corporation has its principal place of business (such as Denmark in the above example), or by courts of any other Member State where the corporation does business. However, corporate law arbitrators might better avoid conflicts with the laws of other jurisdictions by avoiding overreaching themselves, and, as explained in the following paragraph, would probably be better positioned than national judges to encourage a uniform approach to conflict of laws problems in corporate law throughout the EU.

example, refuse to enforce a judgment that it believed conflicted with its capital market law (Germany, in the above example, could refuse to enforce a judgment for breach of fiduciary duty against directors in a U.K corporation having its principal place of business in Germany, if German courts believed that the judgment infringed on Germany's prerogative to permit takeover defences under its capital market law). These enforcement problems would exist, however, whether the judgment was obtained in a forum such as an arbitration panel, or from courts in the Member State of incorporation. Indeed, as pointed out below, the Member State of incorporation, if it wants to, can make arbitration awards at least as enforceable as decisions by its courts, and private parties through contractual arrangements can probably make arbitration awards easier to enforce than decisions of national courts.

3. Incomplete Information About Mutual Recognition and Enforcement of Judgments Within (and Outside) the EU

A Member State can effectively export its corporate law along with adjudication to managers and investors outside its borders only if other Member States will recognize and enforce its judgments. Although EU Member States for the most part do enforce each other's judgments, and are bound to do so, this is not always the case.⁸⁶ In many instances, the critical question is not whether a judgment will be enforced in another Member State, but when. "Eventually" is an insufficient answer if damages cannot be collected because a party has time to remove assets elsewhere. Injunctive relief against share purchases and repurchases, sale of corporate assets, interested director transactions and similar conduct may not be meaningful unless enforcement is immediate. The prospect of going back to court in the state of incorporation for a contempt order, or awaiting resolution of a frivolous appeal before an injunction will be enforced in another Member State may render the injunction worthless. This problem alone could be a compelling obstacle to Member State A marketing its corporate law, and adjudication system, to managers and investors whose assets are concentrated in Member State B.

Unbundling corporate law from adjudication could help solve this problem. A choice of forum clause in a corporate charter should be relatively easy to enforce, particularly if there is express statutory authority for it in the Member State of incorporation.⁸⁷ Adjudication in Member State B, an option discussed in more detail in Section EII below, thus may be a solution to the enforcement problem if the relevant parties or assets are in Member State B and Member State B's courts can be trusted to competently apply the corporate law of Member State A. Once a matter is adjudicated, at least Member State B is likely to effectively and quickly enforce its own court orders. This could be more important than the arguably more accurate adjudication of corporate law that would be obtained if the matter were heard in Member State A.

It is also possible that arbitration awards would be easier to enforce, and would be enforced more quickly, than judgments of courts of individual Member States. The Member State of incorporation could at least put arbitration awards on a par with judgments of its own

⁸⁶ [discuss exceptions].

⁸⁷ Choice of forum clauses in commercial agreements are widely enforced, and courts have incentives to enforce them in part because doing so is relatively easy (dismissal on *forum non conveniens* grounds), compared with the complexities sometimes involved with enforcement of choice of law clauses. See Larry E. Ribstein, From Efficiency to Politics in Contractual Choice of Law, 37 Ga. L. Rev. 363, 421-22. Arbitration clauses also are widely enforced, *id.* at 423, but to the extent arbitration is unpredictable because arbitrators do not rely on precedent, parties may prefer to rely on choice of a judicial forum instead. *Id.* at 424.

courts by providing in its statute that, once an arbitration award is handed down, any interested party can apply for an equivalent court order. Private contracting could also be used to make an arbitration award at least as, and perhaps more, enforceable than a court order in the Member State of incorporation. Arbitration clauses in corporate charters, shareholder agreements and managers' employment agreements could specifically provide that, once a corporate law question is adjudicated, enforcement can be obtained in any court in the EU or outside the EU. Refusal to abide by the arbitrator's decision thus could lead to enforcement proceedings in the courts where investors or managers reside, assuming they had contractually bound themselves to the arbitration process under the laws of their own jurisdictions. Non-EU domiciled investors and managers in particular might be easier to reach through arbitration clauses enforceable in their own countries than through requests that courts in their countries enforce corporate law judgments from within the EU.⁸⁸ Rather than wait for the sometimes Byzantine procedure through which courts enforce foreign judgments to play itself out, investors and managers thus could opt into speedier enforcement mechanisms, once the adjudication process is unbundled from the law of the state of incorporation.

4. *Incomplete Information About the Learning Process for Judges*

Judges in some Member States have more experience with corporate law than do judges in other Member States. Few European judges, however, specialize in corporate law, as do judges in Delaware, and European judges' professional reputations are unlikely to turn on expertise in corporate law.⁸⁹ Few European judges outside the U.K. also have much experience applying their corporate law to entities having a principal place of business elsewhere. Furthermore, the long dominance of the seat theory in much of Europe meant that, before *Centros* and *Inspire Art*, even judges in the UK did not have an opportunity to apply UK law to Continental enterprises.

Judges in most EU Member States, furthermore, are political appointees with fixed tenure. Their length of service and compensation do not depend upon whether persons who use their courts trust them to make the right decisions. In many European jurisdictions, unlike the United States, the judiciary is a specialized career that one enters shortly after university training and without significant experience in private practice. Lack of practice experience does not facilitate learning how to adjudicate disputes arising out of complex corporate transactions. Incomplete information about the learning process for judges, particularly foreign judges, thus could discourage managers and investors from entrusting corporate law adjudication to judges in jurisdictions other than their own.

And what if the judges get it wrong? In the United States, the Delaware legislature can step in and has done so.⁹⁰ The learning process for Delaware judges is also informed by

⁸⁸ For example, enforcement of arbitration decision in the US is governed by the Federal Arbitration Act (FAA), which provides in §201 et seq. that federal courts enforce arbitration decisions in accordance with the UN Convention on the recognition and enforcement of foreign arbitral awards, provided the petition for enforcement has been filed within three years of the arbitration awards. See § 208 FAA (Residual Application).

⁸⁹ Germany is one of the few Member States that encourages specialization among its judges, with special courts dedicated to labor law, administrative law, and constitutional law, and specialized panels within courts that focus on corporate law.

⁹⁰ See text accompanying note 50 supra. Judges of course could get it right in the first place and the legislature then get it wrong when correcting the judges' decision. Still, however, both judges and legislatures can learn from each other and judges probably do a better job adjudicating corporate law, and of articulating good reasons

the “shadow” of federal intervention if Delaware judges interpret statutes in a manner that federal regulators believe is unreasonable (some changes in Delaware adjudication of takeover law, for example, have been attributed to the threat of federal intervention in the 1980s).⁹¹ It is doubtful that the “shadow” of EU level intervention is as daunting (particularly given how long it takes to get new EU directives approved and implemented). National legislatures could intervene and change corporate law, but unless judicial error affects domestic interests, legislatures are unlikely to do so. Managers and investors thus would probably prefer to confront slow learning judges in their home country. At least in a corporation’s principal place of business, the prospect of petitioning for legislative reversal of bad corporate law is more realistic. These and related concerns about the quality of adjudication, and how quickly judges will learn how to adjudicate corporate law, pose a high barrier to any Member State hoping to market not just its statutes, but also its courts, outside its borders.⁹²

E. Alternatives to Bundled Corporate Law of a Single Member State

Overcoming barriers to exporting adjudication along with corporate statutes may be a realistic long-term goal. A Member State that, like Delaware in the United States, succeeds in overcoming these barriers will export a “bundled” legal product of probably higher value than a Member State that exports its statutes only, and may reap commensurate rewards. The barriers discussed above in Section D are substantial, however, and at least in the short run Member States should explore strategies to export their corporate statutes without adjudication by national courts. At least initially, some Member States may find that they have to unbundle statutes from adjudication in order to meaningfully participate in legislative competition for corporate law.

Before discussing unbundling alternatives in more detail, we note that two general approaches to unbundling are possible. First, there is “statute unbundling” in which statutes are unbundled from both caselaw and courts, leaving the adjudicator free to decide cases under the statute without relying on judicial precedent in the state of incorporation. The statute only controls, and the adjudicator can develop its own body of interpretive caselaw or decide at its own discretion to draw on interpretive caselaw either in the state of incorporation or elsewhere. Statute unbundling maximizes the adjudicator’s flexibility, but increases the likelihood that different interpretations of the statute will emerge in different adjudicating jurisdictions.

The second alternative is “forum unbundling” in which the incorporation jurisdiction’s statutes and interpretive caselaw are unbundled from the adjudication services of its courts. Corporations may in their charters choose an adjudicator other than the courts of the state of incorporation. The adjudicator, however, is expected to apply the state of incorporation’s

for their decisions, when they know that a legislature can, and is likely to, step in to correct decisions it does not like.

⁹¹ See Roe, *supra* note 45. The federal government may overreact to perceived error in state law and enact inefficient rules, as some commentators argue was the case in the Sarbanes-Oxley Act. See Ribstein, *supra* note 4. Viewed in this light, the failure of the EU to quickly enact corporate and capital market law directives arguably puts the EU at a competitive advantage vis a vis the U.S. Still, however, the unlikelihood of a quick response at the EU level to poor decisions by Member State judges may encourage those judges to be lax about developing good case law and applying it consistently.

⁹² As discussed more fully in Section EIII below, the learning process of corporate law arbitrators might more readily adapt to the needs of managers and investors.

caselaw as well as its statutes, although the state of incorporation's own courts have little or no role in assuring that the adjudicator actually does so.⁹³ Decisions under the same incorporation statute are likely to be more similar across different adjudicating jurisdictions than with statute unbundling, but there is still some risk of divergence because different adjudicating forums may interpret the same statutes and case law differently.

I. Importing Bundled or Unbundled Delaware Law into Europe

Some Member States could expand options available to investors and managers by allowing corporations having a principle place of business within their borders to incorporate in Delaware. In this scenario, the Member State would voluntarily recognize a Delaware charter to the same extent a Member State is required under *Inspire Art* to recognize a charter from another Member State. A few foreign jurisdictions, most notably Israel,⁹⁴ have adopted this solution and allow domestic companies to import Delaware's bundled corporate law product. Some but not all of these corporations have also opted into the United States capital market law by choosing to sell and list securities in the United States.⁹⁵

Indeed, a few European headquartered corporations already have Delaware charters. Most of these, however, are based in the UK,⁹⁶ and the practice does not appear to be widespread. Furthermore, *Centros* and *Inspire Art* do not require a European Member state to recognize a Delaware charter for a corporation headquartered within its borders – Delaware corporations have no right to freedom of establishment under Article 46 of the EC Treaty.⁹⁷ Arguably the German-American friendship treaty and similar treaties between the United States and other EU Member States require recognition, but this is doubtful if a corporation has no United States connection other than incorporation in Delaware.

A European Member State thus as a general matter can, but need not, recognize Delaware charters within its borders. The strongest policy argument for refusing recognition, traditional adherence on the Continent to the seat theory of incorporation, has been undermined by the mandate in *Centros* and *Inspire Art* requiring recognition of other European corporate charters. If these charters must be recognized and the seat theory is gone, presumably Delaware charters should be recognized as well. Such arguments, however, are

⁹³ This would depend on whether a right to appeal to courts in the Member State of incorporation is provided for.

⁹⁴ See Edward B Rock, *Coming to America?*, supra note 70.

⁹⁵ After the Sarbanes-Oxley Act of 2002 (SOX), this combined package of Delaware corporate law and U.S. capital market law may be more expensive to comply with, and thus less attractive to foreign companies, because under SOX federal securities law intrudes on state corporate law and some provisions of SOX may be particularly difficult for foreign companies to comply with. See Larry Ribstein, *Raising the Rent* supra; Richard W. Painter, *Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 J. Corp. Law 397 (2004) (discussing similar concerns about the SEC's attempt under SOX to regulate foreign auditors and lawyers whose clients sell securities in the U.S.).

⁹⁶ See e.g. 2003 10-Q for Medicsight, Inc. a Delaware corporation, having its principal place of business in London, England (on file with authors).

⁹⁷ The Netherlands, which in the ECJ's *Inspire Art* decision lost its bid to enforce its Companies Formally Registered Abroad Act, has made it clear that "for foreign form companies outside the European Union, such as the 'Delaware Corporation', the Act will remain in force without amendment in any event, without regard to the European Court ruling." See <http://www.kvk.nl/artikel/artikel.asp?artikelID=16069§ieID=102> (webpage of the Netherlands Chamber of Commerce)

unlikely to persuade many Member States, reluctant to part with the seat theory to begin with, that they should go beyond that which is required under *Centros* and *Inspire Art*. Furthermore, recognition of Delaware charters by EU Member States could allow Delaware to expand its commanding position in corporate law, causing legal and other jobs related to corporate law to migrate from the EU to Delaware.

This “Delaware” solution also may not be easy to sell to investors or managers. First, Europeans may doubt the quality of the Delaware product. For example, by European standards, manager compensation routinely approved of by Delaware courts is often excessive. In other areas as well Delaware is believed, particularly in Europe and also by some United States scholars,⁹⁸ to be too deferential to corporate management. Some European shareholders may, for these or other reasons, want nothing to do with Delaware. Second, a Delaware charter could interfere with marketing a corporation’s product in Europe and with attracting managers and employees. Even if “European” in all aspects other than the law applicable to its internal affairs, it could still be perceived to be an “American” corporation. If this “Americanized” image brought more negative connotations than a corporate charter from another EU Member State, investors and managers might decide to incorporate within the EU instead. A third disadvantage of the Delaware charter is that the corporation, while recognized in an individual Member State that wishes to recognize it, would not be a European entity and thus might lack standing as well as substantive legal protection under European Community law (for example the corporation might not be able to petition EU courts or other EU bodies). Fourth, managers and investors with disputes under Delaware corporate charters would have to incur the inconvenience of having these disputes adjudicated in Delaware. For all of these reasons, Member States will probably not allow Delaware charters to be used by corporations headquartered within their borders, and even if Delaware charters are allowed, investors and managers may not choose them.

A second alternative would be for a Member State to copy parts of Delaware’s statutes or case law and integrate them into its own “home-grown” bundled product of statutes, case law and adjudication. Including some rules from Delaware law in the bundled product of a Member State might, or might not, improve the quality of its corporate law, a question that turns in part of the comparative advantages of specific Delaware rules vis a vis their Member State counterparts and in part on how Delaware rules would fit into the Member State’s corporate law as a whole.⁹⁹ Most important for the present analysis, however, most of the barriers to entry for Member States offering a bundled product in Europe that are discussed in Section D above would not go away merely because a portion of that bundled product was copied from Delaware.

A third option would be for a Member State to copy all or substantially all of the Delaware General Corporation Law and adopt it as its own law, while still providing for adjudication in that Member State’s own courts in accordance with their own precedent (although that Member State’s courts might on their own accord sometimes look to Delaware cases for interpretive guidance). This would be similar to statute unbundling except that the Member State would be the state of incorporation, not Delaware. This arrangement would not, however, allow the Member State to fully realize all of the value of the Delaware corporate law product, much of which is tied up in Delaware case law, because courts would have the option of departing from Delaware law. Furthermore, the Member State offering this

⁹⁸ See text accompanying notes 45-49 *supra*.

⁹⁹ See generally, Kraakman, et al. *supra* (discussing the comparative advantages of different approaches to corporate law across legal systems). To the extent national corporate laws are designed comprehensively to address agency problems, mixing concepts from different legal systems could leave more agency problems unsolved than adopting any one system in its entirety.

bundled product -- its own statute copied from Delaware's statute coupled with adjudication by the Member State's own courts -- would still have to overcome many of the barriers to entry to offering a bundled product that are discussed in Section D above.

The fourth alternative would be for a Member State to adopt Delaware statutes and case law as its own by providing for adjudication in its own courts and legislatively mandating that Delaware case law is binding. The Member State would thus repeal its own prior case law and statutes and substitute law identical to that of Delaware. This alternative would capture some of the value of Delaware case law (along with its weaknesses), but at a cost. Judges would have to read and follow Delaware cases, potentially a problem in non-English speaking countries. Even if language barriers were overcome, European judges, because of their different legal education and experience, might not replicate the work product of Delaware judges when applying Delaware corporate law. The Member State's judges would perhaps frequently reverse their own decisions after commentary by American experts on Delaware law or new developments in Delaware. Indeed, such an arrangement would resemble adjudication in Delaware itself before the mid 1770's, when local courts in the British colonies tried at a distance to come as close as possible to following English case law. There would, however, be no actual sovereignty relationship between Delaware and the Member State, and thus there would be no opportunity for a party to appeal to Delaware a decision that it believed to be an erroneous interpretation of Delaware law. Most European countries would also encounter political difficulties instructing their judges to treat the case law of an American state as binding. Some Member States, such as the U.K., are used to the "colonial" relationship being the other way around. Finally, the Member State offering law copied in its entirety from Delaware's still would not avoid many of the barriers to entry to offering a bundled product that are discussed in Section D above.

It is also important to recognize that all four of these hypothetical "Delaware" based products (bundled and unbundled Delaware law) would cause the adopting Member State, and incorporators who used that Member State's charter, to incur costs related to the "transplant effect" that comes when legal rules that function well in one jurisdiction are used in another jurisdiction with a different legal and cultural background.¹⁰⁰ Only the first of the above options, allowing companies headquartered in a Member State to use Delaware charters, avoids the impact of the transplant effect on a Member State's own corporate law. This first alternative still, however, risks the transplant effect of allowing Delaware law to determine relationships between investors and managers within the Member State's borders. Only the second alternative, using portions of Delaware law in a genuinely home grown legal product of a Member State, allows for gradual assimilation of useful legal concepts from Delaware law and could minimize the transplant effect if the provisions copied from Delaware are chosen carefully. The third alternative, wholesale adoption by a Member State of Delaware statutes, and the fourth alternative, wholesale adoption by a Member State of Delaware statutes and case law, maximize the transplant effect.

For all of the above mentioned reasons, it is likely that none of the "Delaware based" solutions, whether involving bundled or unbundled Delaware law, is viable for Europe. A Member State that wants to make its corporate law attractive to users beyond its borders will probably have to look elsewhere.

¹⁰⁰ See Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, *Economic Development, Legality and the Transplant Effect*, 47 *European Economic Review* 165 (2003); Lynn A. Stout, *On the Export of U.S. Style Corporate Fiduciary Duties to Other Cultures*, in *Global Markets, Domestic Institutions, Corporate Law and Governance in a New Era of Cross-Border Deals* (Curtis J. Milhaupt, Ed.).

II. Adjudicating Corporate Law in Another Member State Forum

One alternative is for disputes under one Member State's corporate law to be resolved by the national courts of another Member State. This could be a Member State that is the "seat" of the corporation, or the place where it has its headquarters and does a majority of its business. Under this scenario, corporate governance disputes in a UK corporation having its headquarters in Munich would be decided by a German court applying UK company law. Alternatively, there could be a "jurisdiction" clause in the corporate charter that specifies the Member State in which suits shall be adjudicated.

Member states using this approach might experience difficulties similar to those that arise when corporate law disputes in the U.S. are adjudicated outside the state of incorporation for one of two specific jurisdictional reasons. First, federal courts sometimes have "diversity jurisdiction" over state corporate law claims when parties reside in different states. Because the Supreme Court's decision in *Erie R.R. v. Tomkins*¹⁰¹ requires federal courts in diversity suits to apply state substantive law, including state case law, diversity jurisdiction involves forum unbundling rather than statute unbundling. Second, courts in one state occasionally interpret and apply the corporate law of another state because the parties bring suit outside the state of incorporation. Here also forum unbundling is involved because courts generally look to both the statutes and the case law of the state of incorporation. Both of these contexts, however, arise only in a narrow range of circumstances, and the forum selection is generally made by litigants ex-post (after a claim arises) because under specific jurisdictional criteria a forum is available other than the state of incorporation. The forum unbundling is not usually contemplated ex-ante and is not the result of private ordering in which managers and investors agree to opt out of the state of incorporation's adjudication system.

The first difficulty is that forum unbundling of this sort usually requires that the forum jurisdiction, while bound to the substantive case law of another jurisdiction, be allowed to use its own procedural law (filing deadlines, briefing procedures, etc.). Procedural and substantive law, however, are not always easy to distinguish. Even in the United States, where there is substantial similarity among jurisdictions in procedural and substantive law, federal courts struggle with this distinction under *Erie* and its progeny, and state courts often struggle with similar issues when deciding cases under the laws of other states. This problem would be magnified in Europe where there are greater differences in procedural and substantive law among the Member States. It is thus very likely that courts agreeing to hear cases brought under the corporate law of another Member State will struggle with distinguishing procedural from substantive law, and the consequences of a wrong resolution of this question could be severe.

For example, every state in the United States and some jurisdictions in Europe allow shareholder suits for money damages. Some Member States such as Germany, however, limit or deny suits for money damages in actions over the internal affairs of a corporation. This is partly due to the fact that the German Stock Corporation Act only provides for actions to set aside (AktG. Section 246) and to annul (Section 249) corporate decisions. These actions may be powerful instruments in the hands of stockholders, but do not provide for money damages.¹⁰² What if a shareholder of a corporation incorporated in Member State A that

¹⁰¹ 304 U.S. 64 (1938).

¹⁰² See AktG § 249 (Nichtigkeitsklage), and § 246 (Anfechtungsklage). For English translation, see Schneider, Hannes, Heidenhain, and Martin, *The German Stock Corporation Act, Bilingual Edition with an Introduction to the Law*, C.H. Beck, KLUWER (1996).

allows suits for money damages is required because of forum unbundling to sue in Member State B that does not allow suits for money damages? Will the courts of Member State B hear the suit because money damages are a substantive part of the corporation law of Member State A? Lacking procedures for determining money damages in suits over the internal affairs of a corporation, the courts of Member State B might copy the procedures of Member State A or might improvise their own procedures. Alternatively, will the courts of Member State B avoid this problem by deciding that the money damages issue is “procedural” and refuse to hear the claim? If so, the corporate charter, by selecting Member State B as a forum opts out of an important part of the substantive corporate law of Member State A, even if Member State A ordinarily does not allow corporate charters to opt out of suits for money damages. Presumably, once Member State B is selected as the forum, there is no appeal to courts in Member State A to restore the shareholder’s right to money damages.¹⁰³

Language barriers and differences in legal systems pose a second difficulty for this type of forum unbundling. French judges deciding cases brought under UK corporate law would have to read both UK statutes and judicial opinions in English, German judges would have to interpret statutes and cases written in French, and so forth. Private parties choosing to incorporate in Member State A but to adjudicate in Member State B that has a different primary language and/or a different legal system would thus impose a significant burden on judges in Member State B (while Member State A would get most of the benefits from having the corporate charters). This burden could be minimized if the courts of Member State B referred only to the statutes and not to the case law of Member State A, but this imposes statute unbundling instead of forum unbundling on users of Member State A’s corporate law. If Member State A is a common law jurisdiction or a civil law jurisdiction that relies on judicial precedent, this statute unbundling by the courts of Member State B could lead to a result different from the result which would have been reached if adjudication had remained in the courts of Member State A. Investors and managers who wanted to choose all of Member State A’s corporate law, including its case law, when they incorporated there are thus likely to be disappointed with resolution of their corporate law questions in Member State B.

In summary, one Member State’s courts could hear suits under the corporate law of another Member State, and in some instances will do so as private actors incorporate abroad after *Inspire Art* but choose to litigate at home. Nonetheless, the aforementioned difficulties suggest limits to jurisdictional competition in Europe that relies on unbundling of this sort. Some Member States may lack confidence in the ability of courts in other Member States to faithfully apply their corporate law and thus refuse in their statutes to allow corporate charters to opt into adjudication by the courts of another Member State. Some Member States may refuse to allow their judges to hear cases under the laws of another Member State, regardless of what private parties desire, because the burdens on their adjudication systems are unacceptable. Finally, some private parties may reject such an arrangement or at least look for a better alternative.

¹⁰³Even apart from the question of money damages, procedural and substantive law may prevent a German court from applying the law of another Member State, such as the UK. German courts are bound by the two aforementioned ways of remedying conflict over the internal affairs of a corporation. Although these are procedural provisions, they are located among substantive law in Germany’s Corporation Act and are directly tied to these substantive provisions. This combination of substantive and procedural law, especially in §245 AktG, which provides that only specified individuals can bring a suit over the internal affairs of a corporation within four weeks of a corporate decision, makes it difficult for German courts to address corporate internal affairs issues under another Member State’s law.

III. Arbitrating

1. *A General Framework for Arbitration of Corporate Law in Europe*

An attractive alternative is adjudication by panels of professional arbitrators. Member States could specifically provide in their statutes an “arbitration enabling provision” allowing corporate charters to mandate arbitration of disputes over the internal affairs of the corporation instead of adjudication in national courts.¹⁰⁴ The statute should then provide that an arbitration award has the same force as a judgment from a court, and should probably also provide that any interested party can apply for a court order in that Member State replicating a final decision in arbitration.¹⁰⁵ While nonpublic corporations should be permitted to opt into either unpublished or published arbitration decisions, because of cost, privacy and other concerns, public corporations probably should be required to use only published arbitration decisions, which would inform public stockholders of the reasons for a decision and provide precedent for future decisions involving other public corporations.

The arbitrators could specialize in the corporate law of a particular Member State, but could be citizens of different Member States and could decide cases in a location outside the state of incorporation. Many presumably would have practiced corporate law prior to becoming adjudicators, positioning them higher on the learning curve than most European judges. They could conduct their hearings in any language, although they would have to be familiar with the language of the Member State of incorporation. These arbitrators also would probably apply uniform procedural rules determined by a private arbitration association rather than by national courts. In published opinions, they would be expected to state reasons for their findings and to follow precedent established by the courts of the Member State of incorporation. Appeal of questions of law to larger “en banc” panels of arbitrators could also be provided for, with decisions of those panels also being precedent for future arbitration decisions.

Arbitrators generally do not have fixed tenure or salaries, and are compensated according to the number of cases they hear. This approach gives litigants a substantial role in shaping the arbitration system, but may result in decisions that are so eager to please all parties that they lack decisiveness or sound legal reasoning and thus lack value as precedent. This is probably not optimal for corporate law arbitration, which must appeal to its users ex-ante (at the time an arbitration clause is adopted in a corporate charter) rather than ex-post (after a

¹⁰⁴ The provision could perhaps be modeled on Delaware’s forum selection and arbitration enabling provision for LLCs. See note 52 *supra*. Another model could be the Federal Arbitration Act in the United States or one of the various similar provisions that have been enacted by various EU Member States, although the arbitration provision contemplated here would extend only to matters of corporate law.

¹⁰⁵ Rights of appeal to national courts in limited circumstances could or could not be provided for in the Member State’s corporate statutes, or corporate charters could be allowed to address this issue (for example, by providing for appeal to national courts only if there is “a gross abuse of discretion by the arbitration panel.”)

dispute has already arisen).¹⁰⁶ Quality case law and predictability, rather than satisfying both parties in a particular dispute, should be priorities, and issues such as tenure, compensation and selection of arbitrators should be addressed with these priorities in mind. Fixing these, as well as other particulars of an arbitration framework, however, would be a matter of private ordering for arbitration associations, and is probably best not dictated by the Member State of incorporation.¹⁰⁷

The specifics of a successful arbitration system also depend in part on the substance of the statutory regime it is designed to enforce. An arbitration system that gave shareholders fewer opportunities to litigate, and that imposed harsher procedural rules, might best be paired with a statute that gave shareholders broader governance rights within the corporation, and vice versa. An arbitration regime designed to handle derivative suits and other forms of group shareholder litigation would be more complex, and expensive, than one designed to implement a statute that omitted these types of remedies and instead focused, as much of European corporate law now does, on remedies for individual shareholders and small groups of shareholders. Given proper incentives,¹⁰⁸ private ordering should design arbitration systems to adjudicate at least the most commonly used corporate law statutes.¹⁰⁹

This, like any private ordering regime, requires adequate incentives for private actors to design and implement the regime, and these incentives cost money. Necessary funding could come from a combination of fees paid to arbitrators for hearing specific cases and fees paid on an annual basis to an arbitration association when a corporation opts into the association's arbitration system ex-ante in its charter. Like a corporate franchise tax, these fees could be adjusted on a sliding scale depending on capitalization or other relevant criteria.

¹⁰⁶ Arbitrators, it is commonly believed, in order to maintain their popularity with all litigants, tend to hand down "centrist" decisions that "split the difference" between the parties. This may be a poor way to create decisive corporate law having value as precedent. If this aspect of arbitration is worrisome, arbitration associations can change the methods for appointing arbitrators (for example instituting random assignment of arbitrators to cases instead of allowing litigants to choose).. As pointed out elsewhere in this Article, just about any institutional characteristic of national courts (long tenure, random assignment, published opinions, etc.) that arbitration associations believe contributes to high quality case law can be instituted within a private ordering context. Institutional characteristics of national courts believed to be counterproductive can be omitted.

¹⁰⁷ The arbitration system we contemplate here would probably be different and more complex than that used for many commercial disputes, thus sacrificing some cost savings normally associated with arbitration. Cheap adjudication, however, is not the objective, whereas borrowing positive characteristics, without the pitfalls, of adjudication by national courts is. Also, as discussed above, adjudication of corporate law disputes in national courts could in some circumstances be so costly for Europeans that even a relatively expensive arbitration regime would be an attractive alternative.

¹⁰⁸ Incentives for arbitrators are an important component of an arbitration system. These incentives can be designed by the arbitration system's architects but in practice depend also on the intensity of demand for arbitration as an alternative to adjudication by national courts (i.e. the overall success of the arbitration system).

¹⁰⁹ A Member State's corporate law statute would probably have to show promise of being attractive to a substantial number of users before an arbitration association would invest in designing a framework for its adjudication. This could present difficulties if users are unwilling to reveal preferences for a statute before an acceptable adjudication system is in place. For this reason, arbitration systems initially might be built around statutes that are already popular, such as U.K. company law. If arbitration was successful in this context, arbitration systems tailored to other Member State statutes might also emerge.

Lawyers who represent clients in arbitration proceedings could also be required to contribute to the costs of the arbitration system. Some of these funds could be spent on infrastructure, such as designing the system, selecting arbitrators and keeping track of precedent, while other funds could be used to compensate arbitrators. Evaluating and compensating arbitrators according to the value of their decisions as precedent could be part of the scheme. Arbitrators could also elect colleagues to appellate panels, and arbitrators who demonstrated commitment to developing good case law, and thus increasing the value of the arbitration system, would presumably be preferred candidates for such positions.¹¹⁰

An important area for flexibility is the weight given to arbitration decisions as precedent, which could increase over time as arbitrators become more confident in their own decisions. While precedent makes corporate law predictable, bad precedent makes bad corporate law. Arbitrators' decisions traditionally are not viewed as binding precedent, and arbitration decisions, as opposed to actual case law from the Member State of incorporation, probably should not be binding precedent in the beginning. Later, when arbitrators are higher on the learning curve, arbitration associations could increase predictability by instructing arbitrators to treat some arbitration decisions as binding precedent if they do not conflict with judicial case law in the Member State of incorporation.¹¹¹ Arbitrators could even decide in separate larger panels which decisions should be treated as precedent and which not, and perhaps even restate the rationale for these decisions.¹¹² The Member State of incorporation probably should leave the arbitration-decisions-as-precedent issue to arbitration associations to work out, although the Member State of incorporation might give some intellectual property protection to an arbitration association's own body of corporate law precedent so there is incentive to create that precedent without fear that it will later be expropriated by another competing association of arbitrators.¹¹³

¹¹⁰ An arbitration system needs incentives for its arbitrators, just as any private organization of professionals, such as a hospital or law firm, needs incentives for its members. There is, however, little reason to believe that public ordering is better at giving national judges incentives to make their adjudication system attractive to users (as opposed to merely acceptable to users who until recently under the seat theory had no alternative). Given the rigidity of public pay scales and civil service regulations, national judicial systems may have less flexibility in addressing incentive issues than private arbitration associations.

¹¹¹ We suggest in text accompanying note 105 *supra* that nonpublic corporations should probably be allowed to opt for unpublished arbitration awards. To the extent nonpublic corporations choose this option, these awards and the arbitrators' reasons for these awards, would fall outside the realm of useful precedent.

¹¹² The parties to an arbitration proceeding have little incentive to demand that the arbitrators provide the law making functions of appellate judges because the benefits are generally external to the parties. See William M. Landes and Richard A. Posner, *Adjudication as a Private Good*, 8 J. Legal Stud. 235, 238 (1979). Arbitration thus can be at a competitive disadvantage compared with public adjudication in creation of valuable precedent. *Id.* Nonetheless, an arbitration association that wants to increase the value of its adjudication product can provide incentives for arbitrators to create precedent and then pay for these incentives out of fees charged to users of the arbitration system. Such an arbitration system might not prioritize reaching the quickest and cheapest possible adjudication of a given case, but nonetheless might have more long term viability in the market for corporate law.

¹¹³ In the public ordering context, courts create valuable judicial precedent, and lawyers help create this precedent without legal rules being given intellectual property protection. Lawyer licensing rules that allow only certain lawyers to practice before courts in a particular jurisdiction, however, may provide comparable protection

Arbitration decisions, however, would not be the only precedent. Arbitrators would decide cases against the shadow of decisions interpreting the same statutes by national courts in the state of incorporation (unless the arbitration system is universally perceived to be superior, at least some incorporating parties, particularly those having their principal place of business in the Member State of incorporation, would choose to have adjudication in national courts). To avoid confusion, case law in national courts (at least appellate courts) should trump arbitration case law, and arbitration associations should insist that arbitration be consistent with national corporate law. Nonetheless, adjudicators in the two different fora could learn from each other's decisions.¹¹⁴

Finally, arbitration is likely to be a politically popular alternative because lawyers in a Member State that allows arbitration retain many advantages that lawyers normally have when private actors use a jurisdiction's courts as well as its corporate law.¹¹⁵ Lawyers in a Member State that successfully markets its corporate law without courts can still try cases

to those lawyers most likely to have invested effort in creating legal rules. See Larry E. Ribstein, *Lawyers as Lawmakers*, supra. Nonetheless, expanding intellectual property protection to legal rules may further increase lawyers' incentives to create valuable law. See Bruce H. Kobayashi and Larry E. Ribstein, *Class Action Lawyers as Lawmakers* (working paper) (discussing the possibility of extending intellectual property protection to class action complaints). The same may also be true for arbitrators who have more incentive to create valuable corporate law precedent if that precedent cannot simply be expropriated by other arbitrators. Some methods of extending intellectual property protection to precedent, such as prohibiting other arbitrators from citing it as authority, however, might be counterproductive and reduce the overall quality of corporate law.

¹¹⁴ Judges at parallel levels likewise learn from each other when federal courts in the United States interpret state corporate law in cases that for jurisdictional reasons (diversity jurisdiction, pendant jurisdiction, etc.) are litigated in federal court. While a state supreme court's interpretation of its own corporate law is the last word (unless federal statutes or constitutional law is also involved), a federal court's interpretation of state corporate law can inform later state court opinions and thus be a useful part of the learning process for state judges. In smaller states that do not have a lot of their own corporate case law, the role of federal adjudication in the learning process can be important. See e.g. *Joy v. North*, 692 F.2d 880, 884-86 (2nd Cir. 1982) (interpreting Connecticut law on the "business judgment rule"), and subsequent Connecticut state cases, e.g. *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253 (Conn. 1994) ("This is the first occasion that this court has had to determine the scope of the business judgment rule in Connecticut. Originating at common law, the rule has previously been construed under Connecticut law by the Second Circuit Court of Appeals, see *Joy v. North* . . ."). Far from creating confusion, such parallel decisions in two different fora can improve the quality of corporate law as adjudicators learn from each other. The same could be true when some corporate law disputes are adjudicated by arbitration panels (if the parties chose arbitration in their corporate charters) and other corporate law disputes are adjudicated by national courts.

¹¹⁵ The traditional view that lawyers, particularly trial lawyers, are hostile to arbitration comes from the notion, common in the United States, that arbitration is a simpler, faster and cheaper alternative to national adjudication. The arbitration system we envision is designed with other priorities in mind, and there is no inherent reason why a lawyer handling a case before corporate law arbitrators should earn less than if the same case were before a national court.

before arbitrators and advise parties who have cases before arbitrators.¹¹⁶ If the availability of arbitration entices more users of the corporate law from other Member States, these lawyers will handle more cases, and presumably earn more money. These lawyers can even become arbitrators themselves, and will always have a competitive advantage because of their familiarity with their own Member State's law. Lawyers are likely to be familiar with procedural aspects of arbitration as well, in marked contrast with the unbundling alternative that is least likely to be popular with state-of-incorporation lawyers -- adjudication in the courts of another Member State.¹¹⁷ Although it is not clear that the role of lawyers, and in particular lawyers' financial incentives, will be as important to designing corporate law in Europe as in the United States,¹¹⁸ corporate law arbitration is not an idea that inherently should be opposed by lawyers, and if arbitration attracts more users of a Member State's corporate law lawyers should embrace it instead.

2. *Arbitration as a Viable Alternative in Europe*

The theoretical attractiveness of arbitration of corporate law disputes raises the question of why it has not been adopted already in the United States, a country that has endorsed wide use of arbitration in a broad range of other contexts. Several American experts, mostly notably Professor John Coffee, have commented on whether arbitration of corporate governance disputes would be desirable in the United States.¹¹⁹ Coffee observed that, among the various states in the United States, "[o]nly in Delaware can the litigants probably expect a state trial court to have the same sophistication and expertise as an arbitration panel."¹²⁰

Nonetheless, Coffee concluded that arbitration of corporate governance disputes would not likely emerge as a viable alternative in the United States, and he discussed in detail numerous objections that would likely be raised. Although most of these objections could be resolved if sufficient investment were made in designing an arbitration framework, this

¹¹⁶ Lawyers may use their influence in drafting their jurisdiction's corporate law to make sure that adjudication takes place in a forum where litigants need their services. This forum is commonly assumed to be the state of incorporation itself. See Ribstein, *Lawyers as Lawmakers*, supra at 349. This assumption is premised in part, however, on a starting point, as Delaware lawyers now enjoy, in which a large number of corporations already use Delaware courts. An arbitration enabling provision in the Delaware General Corporation Law thus would probably be unpopular with the Delaware bar, although Delaware lawyers did not strongly resist the arbitration provision in Delaware's LLC statute (Delaware has nowhere near the dominance in LLCs that it has in corporate law). From the vantage point of lawyers in a jurisdiction that has not yet attracted a large number of corporate charters, arbitration should be viewed more favorably, particularly if the alternative is lower usage of the jurisdiction's corporate law because corporations don't want to litigate in its courts. The other bad alternative, from the perspective of state-of-incorporation lawyers, is adjudication in national courts of another jurisdiction, a likely prospect in Europe if managers and investors in one Member State do not want to litigate in the courts of another. In sum, given that no Member State has the starting position that Delaware now enjoys, arbitration may be viewed by many lawyers as their own Member State's best alternative.

¹¹⁷ See Section EII supra.

¹¹⁸ See note 26 supra.

¹¹⁹ See John C. Coffee, *No Exit? Opting Out: The Contractual Theory of the Corporation and the Special Case of Remedies*, 53 *Brooklyn L. Rev.* 919, 921 (1988).

¹²⁰ *Id.* at 957.

investment has not been made in the United States and, since Coffee's article, arbitration of corporate governance issues has not taken hold. This is probably due not only to the specific objections to arbitration that Coffee observed but also to a high level of confidence among managers and investors in Delaware's existing adjudication system. Arbitration of corporate law disputes may be the next best alternative to Delaware, but a second place finish in regulatory competition probably does not justify the investment needed to design an arbitration framework that overcomes many of Coffee's specific objections. Public adjudication always competes with the potential for private adjudication that can take its place, and the fact that private adjudication does not emerge, as it has not emerged in U.S. corporate law, suggests that in a particular setting public adjudication is presently good enough to beat the competition.¹²¹

Europe, however, has no equivalent of Delaware with which arbitration would have to compete. Incorporation theory is just beginning to take hold on the Continent and no Member State has yet established a commanding lead in marketing its corporate law outside its borders. Also, for the reasons mentioned earlier in this article, it may be difficult for a Member State to establish such a leading position if it bundles its corporate statute with adjudication by local judges. Finally, some of the specific objections to arbitration that Coffee raises would not apply if a Member State were to specifically provide for arbitration in its corporation statute, while other objections might be easier to address in the European setting than they would be in the United States.

The first category of Coffee's objections is troubling if the relevant corporation statute does not provide for arbitration and private parties nevertheless seek to mandate arbitration on their own. Absent an arbitration enabling provision in the statute, an arbitration provision in a corporate charter might be unenforceable in Europe as in the United States. For example, United States courts have refused to enforce arbitration provisions concerning matters such as business plans, dividends and dismissal of officers on the grounds that they "sterilize" a corporation's board of directors by taking away board discretion.¹²² Coffee points out, however, that carefully drawn charter provisions can limit arbitration to remedies for breach of fiduciary duty and similar claims, and not allow arbitration to intrude upon the board's discretion as to matters of business judgment.¹²³ It could also be important for corporate charters to limit arbitrators' discretion to grant some types of injunctions, particularly in circumstances where courts would not grant injunctions.¹²⁴ At the same time, the modern trend is to acknowledge the authority of shareholders through corporate charters to restrict directors' authority, and arbitration clauses should withstand judicial scrutiny if they stop short of substituting arbitrators' views for those of directors on fundamental questions of business judgment. In any event, these issues are of far greater concern if the underlying statute does not clarify when arbitration is and is not permissible.

Another similar objection is that arbitration could conflict with express policies in corporate statutes concerning "vested" rights of shareholders (for example shares issued prior to a charter amendment mandating arbitration might have a vested right to sue in court). Still other legal objections can be made, Coffee points out, if the arbitration provision would not be equally binding on all shareholders; allowing some shareholders to sue while others were forced to arbitrate would treat similar shares of stock unequally. Once again, these objections

¹²¹ See William M. Landes and Richard A. Posner, *Adjudication as a Private Good*, 8 J. Legal Stud. 235 (1979); and Gordon Tullock, *Trials on Trial* (1980) (discussing competition between private and public adjudication).

¹²² Coffee, *supra* at 959, and n. 80 citing cases..

¹²³ *Id.* at 960.

¹²⁴ *Id.*

can be resolved with a statute that clearly makes arbitration binding on all shareholders upon adoption of a valid amendment to a corporate charter providing for arbitration.

Coffee's next category of objections concerns the effect that arbitration of one shareholder's claim could have on claims of other shareholders. Once a suit is arbitrated, other shareholders might not be collaterally estopped from bringing the same claim before another arbitration panel. The corporate charter (or the corporate statute allowing for arbitration) could presumably deal with this problem by providing for collateral estoppel, or that other shareholders would have to bring similar claims before the same arbitration panel. Coffee, however, rightly points out that this raises the opposite problem of collusive settlements in which a shareholder, acting in concert with corporate management brings a case to arbitration and accepts a cheap settlement, trying to bind the other shareholders. In order to prevent such collusion, arbitration panels would have to design oversight and notice procedures and other safeguards against collusive settlement similar to those used by many U.S. courts in shareholder litigation. This might be difficult given that "[e]xisting arbitration mechanisms were never designed to substitute for collective proceedings, such as the class or derivative action, in which the interests of numerous persons are aggregated."¹²⁵ Designing arbitration procedures that reproduce procedures already in place in Delaware and elsewhere in the U.S. for derivative litigation thus could be impractical, unnecessarily expensive and duplicative.

Not so in much of Europe. Many European Union Member States do not allow United States style shareholder derivative suits to begin with. Because derivative suits and other forms of group litigation do not necessarily improve corporate governance commensurate with their cost (including the cost of frivolous suits), these Member States may hold fast to the position that derivative suits are an unneeded addition to individual shareholder suits. Other Member States are contemplating broadening derivative litigation,¹²⁶ but have not yet decided whether to do so. Still other Member States may require persons bringing derivative suits to own a certain number of shares (e.g. 3%, 5% or even 10% of the total shares outstanding), in order to mitigate some of the problems associated with U.S. style litigation. Group litigation, to the extent allowed in Europe, is thus likely to be of a simpler version than its counterpart in the United States and is also likely to be less frequent. Such a simpler version of group litigation also may be easier to replicate by a panel of professional arbitrators. This is particularly true if corporate law arbitration in Europe is intended to replicate important aspects of national adjudication rather than be a speedy low-budget alternative.

In any event, most Member States have low or nonexistent "sunk costs" in designing national systems for adjudicating group shareholder litigation, particularly compared with the United States. Member States that have not yet designed an adjudicative framework for protecting shareholders in group litigation, will not necessarily find it more efficient to do so through courts that have little prior experience in this respect, than to do so through the private ordering of arbitration associations. Alternatively, a Member State that believes strongly that group litigation cannot be handled by arbitrators, can always exempt group shareholder litigation from arbitration (e.g. provide in its arbitration enabling statute that arbitration is available only as a means for resolving disputes between individual shareholders and the corporation). Member States choosing this option would only partially unbundle their corporate law from national adjudication, but would at least offer the unbundled alternative for suits in which individual shareholders, managers or directors are the parties.

¹²⁵ Id. at 967.

¹²⁶ See e.g. Press Release 10/03, 25 February 2003, Federal Government to improve investor protection and corporate integrity (*Bundesregierung stärkt Anlegerschutz und Unternehmensintegrität*) (announcing a ten point plan that includes expanded shareholder litigation) <http://www.bundesjustizministerium.de/>

Yet another category of objections that Coffee raises centers on the fact that arbitration panels traditionally award attorneys' fees differently than do courts in the United States, and in a manner that disfavors plaintiffs' attorneys and thus discourages suits. His concern is first that arbitrators might not award sufficient attorneys fees to shareholders who prevail in a suit against management, or at least that arbitration awards of attorneys fees would not be as predictable as formulas used by courts.¹²⁷ Second, Coffee observes that arbitration panels might follow the "English rule" of imposing attorneys fees on the losing party, even if the losing party is an individual shareholder.¹²⁸ Arbitration systems that did not adequately address both of these issues could diminish incentives that shareholders have to bring actions compared with the incentive they now have to sue in the United States.

Once again, however, these arguments are not persuasive in Europe, where court awarded attorneys fees in shareholder litigation are generally lower than in the United States and are in some instances fixed by statute. Many European jurisdictions also follow the English rule of imposing attorneys fees on losing parties, so it makes little difference if arbitrators do the same. Although there are advantages, at least from the perspective of plaintiffs and their lawyers, to the generous approach in the United States to attorneys fees, there are also arguments in favor of the more conservative approach that prevails in much of Europe, where frivolous shareholder litigation and protracted litigation over corporate governance are less common. Finally, it is possible for an arbitration enabling statute to provide that arbitrators shall make awards of attorneys fees commensurate with those that would be given by a court in the Member State of incorporation.

Coffee has one objection to arbitration of corporate governance disputes that is as persuasive in Europe as in the United States. Arbitration, as it is used in most contexts, yields little relevant precedent.¹²⁹ This significantly diminishes the third-party benefit from arbitration, at least compared with a judicial system such as Delaware, and perhaps that of the UK and some other Member States having rich judicial precedent. As already discussed above, however, this is a problem that arbitrators can address if they want to, and they presumably will address it if they want arbitration to be competitive with national adjudication over the long run.¹³⁰ As also pointed out above, however, there are dangers associated with precedent that is binding too early when adjudicators are still at the beginning of their learning curve.¹³¹ Arbitrators have useful flexibility in deciding when and how they will add this extra component of value to their adjudication system.

A final concern is expertise. Would arbitrators really know as much as they should about the relevant corporate law? As Coffee acknowledges, panels of arbitrators who are experts in corporate law would compare favorably with most courts, but might not compare favorably with specialized courts similar to those in Delaware. Such specialized corporate law courts, however, do not now exist in Europe. Judges in the UK and some other Member States have expertise in corporate law perhaps comparable with judges in other large jurisdictions that also do not have a specialized corporate judiciary. Most of these judges are knowledgeable, but a case still might be assigned to a judge who knows little about corporate law, and who cares even less. This prospect is probably more troubling for managers and investors residing outside the jurisdiction who are unfamiliar with its judges. Furthermore, the European custom of committing oneself to the judiciary for a lifetime will not attract judges with practice experience and is not likely to attract judges interested exclusively in deciding corporate law

¹²⁷ Coffee, *supra* at 969.

¹²⁸ *Id.* at 969, n. 110.

¹²⁹ *Id.* at 969.

¹³⁰ See text accompanying notes 111-113 *supra*.

¹³¹ *Id.*

cases. Arbitrators by contrast can be paid more than judges, which increases the quality of available expertise. Arbitrators also have another financial incentive to develop their expertise, and their reputations: many arbitrators will at some point go back into private practice.

Finally, as already pointed out above, judicial expertise is ineffective unless judges can address language barriers. The vast majority of European arbitrations are already conducted in English, and in corporate law cases English would probably satisfy most managers and investors. A corporate charter could also opt into arbitration conducted in French, German or some other language. Special circumstances, such as documentary evidence written in Lithuanian, could be addressed by providing that at least some arbitrators on the panel should know that language. By contrast, requiring a Member State's judiciary to conduct proceedings in English or some other foreign language would be politically contentious, if not impossible. There is also less flexibility with the assignment of cases to judges, and language proficiency is not normally an important consideration (in arbitration, by contrast, the parties normally have a role in deciding who will hear their case). The system of state appointed expert corporate law judges thus may work well in the United States where there is one common language, but in Europe "expert" judges in national courts who cannot understand the arguments of lawyers before them or who cannot read underlying documents written in another language may not be experts at all.

3. *The Legal Standing of Arbitration in Europe*

This article will not review the legal treatment of arbitration in individual European Member States, and recognizes that implementation of a scheme for arbitration of corporate law will probably require statutory changes in one or more Member States. Still, however, European jurisdictions widely recognize and enforce arbitration awards. German and American law on arbitration, for example, are quite similar with respect to such questions as who may arbitrate, the arbitration agreement, what disputes may be arbitrated, the arbitrator, the award, legal representation in arbitration, as well as preliminary and final enforcement measures.¹³² Other similarities include the fact that courts do not intervene unless absolutely necessary or the so-called "hands-off" doctrine, the state's prerogative in certain areas, as well as limitations on what is legally permissible under principles of public policy.¹³³

Arbitration in Europe was encouraged by the signing of three treaties in particular, the Treaty of Friendship, Commerce and Navigation between Germany and the United States on October 29, 1954,¹³⁴ the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards of June 10, 1958,¹³⁵ and the Hague Convention in Civil and Commercial Matters of taking evidence abroad of March 18, 1970.¹³⁶ The stimulant effect of arbitration to international trade was well recognized. The German American Friendship Treaty, for example, allows for arbitration panel decisions to be easily recognized and enforced provided that (i) the arbitration decision was the result of a valid arbitration clause; (ii) the arbitration panel decided within the scope of such clause; (iii) the decision was final and enforceable; and

¹³² See Ottoarndt Glossner, *The Law of Arbitration in the United States and its Relevance for German-American Business Relations*, 5 *Arbitration in US-German Business Relations* 25, German Institute of Arbitration (1995).

¹³³ See Glossner, *supra*.

¹³⁴ See BGBl. II at 487 (1956). See Schwenk, *Der neue Freundschafts-, Handels-, und Schiffahrtsvertrag zwischen der Bundesrepublik Deutschland und den Vereinigten Staaten von Amerika*, JZ 1957, p. 197.

¹³⁵ See BGBl II at 121.

¹³⁶ See BGBl II at 780.

(iv) the decision is not in violation of public principles.¹³⁷ According to the Treaty, dual citizenship is not a requirement for arbitrators, neither is the location of the arbitration hearing necessarily required to be in one of the parties' country of origin. In the ensuing years, arbitration has been widely used in Europe, and in some contexts has even made its way into charters of corporations and other organizations. German law, for example, allows for arbitration clauses in private enterprises and corporations,¹³⁸ provided they are private legal persons rather than public or state owned corporations.¹³⁹ An arbitration provision in the charter of a small privately owned GmbH thus would probably be enforceable under existing German law whereas a similar provision in the charter of a large publicly held AG might not be. Indeed parties forming a GmbH sometimes do seek to contract for both choice of law and choice of forum (arbitration) in disputes concerning their rights and obligations.¹⁴⁰

In order to fully enable corporations to opt into arbitration, a Member State of incorporation should, however, specifically provide in its corporate statute that arbitration is permissible if allowed in either the corporate charter or (for a closely held corporation) in a shareholders' agreement. Otherwise, investors run the risk that courts refuse to enforce the arbitration provision. The Member State of incorporation could facilitate enforcement of arbitration awards throughout the EU and beyond by specifically providing in its corporate statute that its courts would, upon petition from an interested party, issue a court order identical to a final arbitration award. While the legal obstacles confronting arbitration would differ from jurisdiction to jurisdiction, legal obstacles should not prevent a Member State from authorizing and facilitating arbitration of disputes under its corporate laws if it wants to.

Conclusion

Regulatory competition in corporate law faces significant obstacles in Europe. These obstacles make it difficult for Member States, at least in the short term, to export to other Member States both corporate statutes and adjudication of corporate law cases by national courts. At least some Member States may be more successful at marketing an unbundled product of statutes and case law, while allowing private ordering to design an adjudication system for parties that want to opt out of national courts in the Member State of incorporation. In some important aspects, including use of written opinions for cases involving public companies and reliance on precedent, this adjudication system might resemble adjudication in national courts more closely than procedures used today in some forms of arbitration. Compared with adjudication in national courts, however, it would probably be more accurate, more efficient and easier to use.

¹³⁷ See BGBl. See also Rolf A. Schuetz, Dieter Tscherning, Walter Wais, *Handbuch des Schiedsverfahrens, Praxis der deutschen und internationalen Schiedsgerichtsbarkeit* 348 (1985).

¹³⁸ See Schuetz, Tscherning, Wais, *supra* at 11. See also Kleinmann, *Schiedsklauseln in Vereins- und Gesellschaftssatzungen*, BB 1970 at 1076. See also Wieczorek/Schuetz, 1048 n. AI.

¹³⁹ See BGHZ 48, 35.

¹⁴⁰ See e.g. <http://contracts.corporate.findlaw.com/agreements/sagent/isar.jv.1998.04.08.html> (posting of a Joint Venture Agreement, dated April 8, 1998 between Sagent Technology, Inc., domiciled in California, and Isar-Vermögensverwaltung GBR, a German limited liability partnership, that contemplates establishment of a new GmbH in Germany and specifically provides for arbitration of disputes over the rights and obligation of the shareholders in the GmbH which “. . . shall be governed and construed under the laws of the State of California, without reference to conflict of laws and principles. The jurisdiction of the courts of Germany is expressly excluded to the maximum extent permitted by law.”) (posted by Findlaw for Corporate Counsel, Findlaw.com).