CORPORATE CHARTERING AND FEDERALISM: A NEW VIEW

Paper prepared for the meeting of the

Global Corporate Governance Colloquium

at

Stanford University, June 5-6, 2015

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I. Introduction

In a system of federated states such as the United States and the European Union, there are, in general, three alternative approaches to chartering business corporations. The first is the *real seat doctrine*, under which corporations are required to be chartered in – and hence their governance is determined by the law of – the member state where they have their principal place of business. The second is *free incorporation* (or, as it is labeled in the United States, the *internal affairs rule*), under which a corporation is free to obtain its charter from, and be subject to the governance rules of, any member state in the federation, whether or not the corporation does business in that state. The third approach, in turn, is *federal chartering*, under which a corporation receives its charter, not from an individual member state, but from the federal government that oversees the federation as a whole.

For more than 40 years, academic debate about the choice among these three regimes in the U.S. and the EU has focused intensely on what has come to be called *regulatory competition*. The familiar idea is that if – as has long been the case in the U.S. and only more recently in the EU – the prevailing choice-of-law regime provides for free incorporation, the result will be competition among the member states to induce business firms to choose them as the firm's state of incorporation.

Under conventional analyses, this competition for corporate chartering may be active, with some or all states purposefully altering their corporation law to make the state more attractive than others as a jurisdiction in which to obtain a charter or, defensively, at least sufficiently attractive that a corporation already incorporated in the state will not reincorporate elsewhere. Alternatively, the competition may be passive, with few or no states actively modifying their corporation law to make it appealing to business firms, but with corporations themselves actively choosing their state of incorporation according to the appeal of its corporation law, with little or no regard to the state's reasons for adopting that law.

Whether active or passive, the resulting competition is commonly – though often tacitly – assumed to press toward homogeneity in the body of corporate law that is dominant across the member states. This homogeneity could take either or both of two forms: first, most states might be induced to adopt the competitively preferred corporation law; second, most business corporations might be induced to (re)incorporate under a single state's law. In both cases, most corporations are taken to have a shared understanding of what makes a corporate statute attractive. The content of that dominant body of law depends on what – or who – most strongly influences the choice of where to incorporate. On the assumption that such competitive processes are at work, scholarly debate then focuses on the desirability, as a matter of social policy, of the body of corporate law that ultimately results. Those who conclude that the resulting law is privately attractive but socially inadequate often advocate eliminating a corporation's freedom to choose, calling either for the real seat doctrine or, in the U.S., for federal chartering or at least federal specification of particularly sensitive governance elements; those who assess the resulting law more favorably often credit the corporation's freedom to choose as the source of that quality and promote both its retention and the mechanism that drives the outcome.

We wish to raise here the possibility that freedom of choice in corporate chartering induces a quite different dynamic than the one typically framed by the literature. In contrast to the push toward homogeneity anticipated by current commentary, this alternative dynamic leads to substantial *heterogeneity* in the bodies of corporate law adopted by the various states in a federal system. In particular, we argue that – in addition to the familiar regulatory competition -- there exists a second dynamic, which elsewhere we have termed *regulatory dualism*.[1] This dynamic operates in response to two different company strategies concerning where to incorporate. Regulatory dualism reflects the fact that different states will offer corporate law consistent with these different strategies. One or more member states attracts – by design or by accident – companies seeking *market-oriented* corporate law that facilitates efficient corporate transactions and that provides substantial protection for non-controlling outside shareholders, while other member states attract companies seeking *politics-oriented* corporate law that helps promote and entrench the powers of controlling shareholders or managers, including the power to exercise direct political influence over the development of

[1] Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism As a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 61 STAN. L. REV. 475 (2011).

both corporate and non-corporate law that bears on their company's activities. The companies' choice between these strategies serves to facilitate a separating equilibrium in which a company's strategy with respect to corporate law is observable. The two strategies roughly map the primary pattern of U.S. incorporations: companies that seek a broad public market and are concerned that their share prices reflect anticipated fair treatment of non-controlling shareholders choose Delaware, while companies that wish to influence the law in a fashion directed by their own circumstances choose to incorporate in their home state.

An important element of regulatory dualism is that the market-oriented regime and the politics-oriented regime are complementary: each is dependent upon the existence of the other. States offering a market-oriented regime draw off from other states the companies that desire to be chartered under such a regime, reducing the pressure on the exporting states to adopt market-oriented reforms at the cost of diluting the politics-oriented regime attractive to other companies. Conversely, the availability of incorporation in politics-oriented regimes enlarges the opportunity for other states to specialize more intensely on offering market-oriented law without the need to accommodate companies that prefer a politics-oriented regime. If all member states in a federation were obliged to adopt the same body of corporate law, the law that resulted would presumably exhibit a combination of market-oriented and politics-oriented features. Depending on the circumstances, and conditional in particular on the comparative political economy of corporate law formation at the member state and federal level, either the dualist or the uniform system of corporate law could be superior in terms of social welfare.

Although our focus in this essay is on regulatory dualism in corporate chartering, it is helpful to consider regulatory dualism in broader perspective as one among several dynamics through which free incorporation can potentially improve welfare in a federal system. Those dynamics include, prominently, the following:[2]

[2] Adapted from Gilson et al., *supra* note 1, at 480.

Regulatory Diversification*.* The corporations being chartered are heterogeneous with regard to the structure of the corporate law that best suits them. Consequently, there are efficiencies from maintaining two or more alternative legal regimes for corporations to choose among, with each regime designed to deal with the particular characteristics of a distinct set of corporations.

Regulatory Experimentation*.* The corporations being chartered may or may not be homogeneous in terms of the legal regime best suited to them. It is unclear what regime is most efficient, or perhaps even whether efficiency calls for one legal regime or for multiple regimes. Freedom in corporate chartering promotes innovation and experimentation with alternative legal regimes to determine which function best.[3]

Regulatory Competition*.* The corporations being chartered are relatively homogeneous, with the consequence that a single regime of corporate law would, in principle, be most efficient. But a single jurisdiction with a monopoly on corporate chartering cannot be relied upon to promulgate an efficient body of corporate law. Free incorporation holds the promise that the various member states will feel pressure to render their corporate law more efficient as they seek to attract, or not to lose, corporations chartered under that law.

Regulatory Dualism*.* As with regulatory competition, a single homogeneous corporate law regime for all corporations would in principle be most efficient. If a single body of corporate law governs all companies within a given jurisdiction, however, that law may become distorted to serve the special interests of politically powerful constituencies such as controlling shareholders, managers, employees, creditors, or the state itself. Freedom of choice in chartering allows different member states to design their corporate law to appeal to different types of firms. If at least one jurisdiction adopts market-oriented corporate law, it can attract companies whose controlling shareholders or managers prefer such a regime, while leaving undisturbed – or in fact increasing the

[3] This is the familiar Brandeisian notion of federated states as "laboratories of democracy."

local influence of – controlling shareholders or managers who wish to exploit the political influence they have over the government that regulates them.

These four mechanisms are not mutually exclusive. In theory, all four of them could be operating simultaneously. As a result, while the principal purpose of this essay is to demonstrate the insight that can be gained by viewing corporate chartering as a form of regulatory dualism, we do not wish to lose sight of the importance of the other three dynamics just described.

We believe that corporate chartering in both the U.S. and the EU exhibit strong elements of regulatory dualism. But regulatory dualism has been playing out rather differently in those two federations. We will therefore examine them in turn, considering first the U.S. and then the EU.

II. Delaware Corporate Law: Competitor or Complement?

A long-dominant theme in corporate law scholarship is that the state of Delaware competes for corporate charters with other states in the U.S. Some scholars have argued, prominently, that such competition has improved American corporate law.[4] Others have argued, just as prominently, that the result of interstate competition for charters has been a force for the worse.[5] Among both groups, there are scholars who claim that the competition is one-sided, with only Delaware competing actively while the other states remain passive.[6] Yet others have argued that there is no meaningful competition at all, either because state corporate law has long been effectively the same across the United States, or because

[4] *See*, *e.g.*, Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

[5] *See*, *e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974); Lucian Bebchuk & Allen Ferrel, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).

[6] *See*, *e.g.*, Roberta Romano, *The Market for Corporate Law Redux*, ECGI Law Working Paper No. 270/2014, http://ssrn.com/abstract=2514650 (articulating the concept of "defensive competition" by states other than Delaware).

Delaware has by now decisively won whatever competition there might have been,[7] or because state corporation law is at best a second-order factor in determining the productive efficiency of business corporations.[8]

All of these interpretations seem to agree on one important point, however: they assume, explicitly or implicitly, that to the extent that Delaware now is competing, or once competed, with other states for corporate charters, the consequence is to make the corporate law of those other states more like Delaware law. (Recent developments in Nevada's corporate law, which might seem an exception, are discussed below.)

As suggested in the Introduction, we propose a different analysis that is substantially at variance with all those just mentioned. We argue that Delaware corporate law is, to an important degree, not in competition with the corporate law of other states, but instead complementary to it. In effect, Delaware corporate law is addressed to a different group of corporations than is the law of other states, yielding a pattern of incorporation that is effectively a separating equilibrium. If companies in the U.S., regardless of the particular states in which they do business, did not have the alternative of incorporating in Delaware, there would be substantially more pressure on other states to make their corporation law more market-oriented. Conversely, if all American business corporations were required to incorporate in Delaware (or under a national corporation law), the corporate law of Delaware would, in all likelihood, be displaced by a body of law much more attuned to a variety of special interests (that is, more politics-oriented) with deleterious effects on its suitability for the large class of corporations that are currently served by Delaware's market-oriented law.

The corporate law of Delaware currently has a variety of familiar virtues that render it unusually market-oriented. It offers a rich body of precedent that makes it unusually predictable. It is administered by a small group of specialist judges with unusual expertise in corporate law and the transactions in which public corporations engage. Franchise fees paid by

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[7] *See*, *e.g.*, Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

[8] Bernard Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

companies incorporated in Delaware constitute a substantial fraction of the state's annual income, and Delaware's legislators, governors, and judges understand that keeping the law attractive to corporations is important for maintaining both the state's revenue and their own influence on national affairs.

Most important to our analysis however, is the fact that few companies that are incorporated in Delaware do any substantial amount of business there. The result is result that most corporate non-shareholder stakeholders (managers, employees, suppliers, customers, creditors, or communities neighboring the company's facilities) cannot exercise significant political influence over the content or enforcement of Delaware's corporate law, whether those stakeholders are organized at the firm level or across firms.

The result, arguably, is a body of law that is largely oriented toward the interests of corporate shareholders as a whole and thus, arguably, toward the maximization of social welfare.[9] In particular, in comparison to the corporate law of other states, Delaware law permits contests for control of the firm to be substantially, if nonetheless incompletely, disciplined by the stock market. Likewise, Delaware law holds controlling shareholders and managers who face conflicts of interest to relatively high fiduciary standards regarding self-dealing, and limits managerial efforts at self-entrenchment. To be sure, this assessment of the virtues of Delaware law must be qualified to accommodate some managerial influence in choosing the state of incorporation, the result of which is that Delaware law allows corporate boards to insulate themselves more than appears to serve shareholder interests. Allowance must also be made for the influence on law-making exercised by the Delaware corporate bar and judiciary, whose income and importance benefits from a high level of litigation, and who therefore have an interest in a level of doctrinal vagueness and instability that may be higher

[9] *See*, *e.g.,* John Armour, Henry Hansmann & Reinier Kraakman, *What Is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW 28 (Reinier Kraakman et al. eds. 2009). To be sure, the connection between shareholder wealth maximization and the maximization of social welfare is controversial. For a summary of the main arguments in support of this view, *see* Mariana Pargendler, *The Corporate Governance Obsession*, Stanford Law and Economics Olin Working Paper No. 470 (2015), http://ssrn.com/abstract=2491088.

than efficiency calls for.[10] In sum, however, Delaware law can reasonably be classified as market-oriented.

In fact, Delaware's interest in the revenue it obtains from selling its corporate law is so strong, and its susceptibility to the direct political influence of corporate stakeholders is so low, that it is effectively in the same position as would be a proprietary merchant. The fact that Delaware has not been replaced by a private firm that offers standard-form charters that can be contracted into, and arbitrators to resolve disputes under those charters, seems largely contingent. Delaware's principal advantage vis-à-vis such a private supplier of corporate law may in large part simply lie in the predictable stability of the state as a legal entity in the very long term, and the formidable reputation that Delaware corporate law has acquired over the last century. As we discuss below, these unique attributes of Delaware as a chartering jurisdiction complicate comparisons between developments in the U.S. with those in the EU.

Firms that do not incorporate in Delaware generally incorporate in their home state.[11] This reflects the fact that, with the exception of Nevada, no state besides Delaware is seeking to attract chartering business from out-of-state firms. More strikingly, it reflects great indifference among non-Delaware firms regarding the formal (doctrinal) content of the corporate law that governs them, or the quality and experience of the courts that resolve disputes under the law..

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[10] Getting the tradeoff between predicable ex ante rules that in an uncertain environment may turn out to be wrong ex post and flexible standards, like fiduciary duty, that are applied ex post when more facts are known is complicated and depends importantly on the expertise and experience of the judiciary: the better the judiciary, the more uncertainty that a standard can accommodate without increasing the chance of judicial error. *See* Ronald J. Gilson, Charles Sabel & Robert E. Scott, *Text and Context: Contract interpretation as Contract Design*, 100 CORNELL L. REV. 23, 73-75, 92-95 (2014)

[11] *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 386 (2003); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1572 (2002) (describing a bimodal pattern of chartering in which nearly 95% of firms that incorporate outside of their home state choose Delaware).); Matthew D. Cain, Stephen B. McKeon & Steven Davidoff Solomon, *Do Takeover Laws Matter?, Evidence From Five Decades of Hostile Takeovers* (Oct. 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2517513 (finding that approximately 11% – a slightly larger but still small proportion – of companies incorporate outside of their home state but not in Delaware or Nevada).

With some modest exceptions, free incorporation in the U.S. has not resulted in either regulatory diversification[12] or regulatory experimentation.[13]

This bimodal pattern of chartering might be explained in part just by transaction costs: when a company incorporates under the law of its headquarters state it avoids the potential inconvenience of litigating at a distance, as well as the difficulties of locating, and working with, lawyers who are familiar with the law of the state of incorporation. Path dependence may also be a consideration: a firm's initial incorporation may be handled by local lawyers who are most familiar with the corporation law of their own state, and consequently recommend chartering in that state. Daines presents evidence that, at least for companies undertaking an IPO, this theory has some explanatory power: companies advised by local law firms are more likely to incorporate and remain in their home state.[14]

But there is good reason to believe that regulatory dualism is particularly important: companies incorporate in their home state to maximize the political influence of their managers and controlling shareholders with respect to both corporate and non-corporate matters. There is conspicuous evidence of this influence in the actions of state legislatures regarding state corporation law. Most states have adopted more, and more restrictive, statutory antitakeover provisions than has Delaware.[15] Moreover, if – as some argue – states other than Delaware have managed to adopt antitakeover legislation that is only quantitatively, rather than

[12] One exception is Maryland, which modified its corporate law specifically to meet the needs of open-end mutual funds -–for example, by permitting boards to retain the right to issue, from time to time, unlimited amounts of additional stock without further consent from shareholders -– though the importance of that innovation has seemingly been reduced by the subsequent evolution of the business trust.]. Today, the most popular forms for organizing a mutual fund seem to be Maryland corporations, Massachusetts business trusts and Delaware Statutory Trusts. K&L Gates, *Organizing a Mutual Fund* (2013), http://www.klgates.com/files/Upload/DC_IM_03-Organizing_Mutual_Fund.pdf.

[13] In contrast to corporate law, the law of limited liability companies, which emerged in the U.S. only about four decades ago, was in its early stages the object of much experimentation. Delaware is now emerging as the leading jurisdiction for the formation of large LLCs, however, arguably repeating the pattern of regulatory dualism seen in corporation law. Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55 J. L & ECON. 741 (2012) (finding that large LLCs are typically formed either in their home state or in Delaware).

[14] Daines, *supra* note 11, at 1581, 1585.

[15] *See*, *e.g.*, Kahan & Kamar, *supra* note 7, at 740 ("[B]ecause, unlike noncompeting states, Delaware also had an interest in not antagonizing shareholders of companies that it might attract from other states . . . it passed a milder [antitakeover] statute").

qualitatively, more protectionist than is Delaware's antitakeover law,[16] it is not for want of trying. The first generation of antitakeover statutes, adopted in some form by thirty-seven states but not by Delaware, was highly protectionist.[17] The prototypical Illinois statute[18] applied not just to companies incorporated in Illinois but to any company whose facilities or shareholders had a meaningful presence within the state. The statute effectively gave the Illinois Secretary of State broad discretion to block the acquisition of a target company. The protections of the statute had to be triggered by the managers or shareholders of the target company, but after that the Secretary of State was free to respond, in addition and more or less as local politics dictated, to appeals from employees and any other local interest groups that were concerned that the acquisition of the target company would disadvantage them. It was only when the Supreme Court struck down the Illinois statute[19] that the first-generation statutes were abandoned in favor of the more modest second- and third-generation antitakeover statutes, which generally apply only to companies incorporated within the state and give substantially less discretion to state officials.[20]

The most striking evidence of the local political influence of managers and controlling shareholders, however, is that legislatures in states other than Delaware have been remarkably willing to grant, with great alacrity, requests from the managers of individual locally-chartered companies— sometimes supported by the company's in-state employees and their unions—for legislation to shield the company from an imminent takeover that is favored by a majority of the company's shareholders. For instance, Connecticut adopted its second-generation antitakeover statute as a result of pressure from a single firm – the Aetna Life and Casualty

[16] Emiliano Catan & Marcel Kahan, *The Law and Finance of Anti-takeover Statutes*, ECGI Law Working Paper No. 274/2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2517594 (arguing that state anti-takeover statutes are no more restrictive of hostile takeovers than the use of the poison pill, which is permitted under Delaware law).

[17] *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 234 (1985).

[18] Illinois Business Take-Over Act, Pub. Act No. 80-1421, 1978 Ill. Laws 1581 (repealed 1983).

[19] Edgar v. Mite Corp., 457 U.S. 624, 639, 646 (1982) (striking down the Illinois statute as preempted by the federal Williams Act and beyond state authority under the dormant Commerce Clause).

[20] *See* WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 597-84 (4th ed. 2012).

Insurance Company, which was widely viewed as a "first class local corporate citizen."[21] Various other states, such as Pennsylvania, Illinois and Missouri, also enacted antitakeover legislation in response to the immediate interests of a single local company.[22]

Although it is harder to demonstrate, it is also reasonable to expect that a state court, faced with a dispute between a company chartered in the state and another from out of state, is likely to find the interests of the home-state firm particularly salient (although reflecting the framers of the constitution´s similar expectation, federal diversity jurisdiction puts important constraints on this). And there is no reason for such salience to be limited to matters of corporate law. By incorporating in the headquarters state, a firm presumably reinforces the impression that it is particularly interested and involved in the state's affairs. And this may be to the company's advantage in dealing with all aspects of government, from adjudication of disputes with suppliers or customers to obtaining building and other state permits. The company's sustained home state incorporation rather than starting or moving to Delaware may reflect credible moves by the company in a tit-for-tat reciprocity game with home state government.

It is, to be sure, difficult to demonstrate the relative importance of the politics-oriented advantages and the transaction-cost advantages of home state incorporation. But there are strong reasons to believe that the former are dominant, at least among publicly-traded firms. One of those reasons is that companies located in small states are apparently more likely to incorporate locally than are companies located in large states.[23] This pattern of incorporation is awkward to explain with transaction costs. For example, although comprehensive data on choice of counsel is lacking, there is no readily apparent reason why companies in small states would choose local counsel – and thus be fortuitously led to incorporate locally – more often than comparable firms located in large states. But the tendency toward local incorporation in

[21] Roberta Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REV. 111, 123 (1987).
[22] *Id.* at 168.
[23] *See* Bebchuk & Cohen, *supra* note 11, at 395 tbl.5 (showing, for all fifty states, the percentage of firms located in each state that are incorporated in that state, and revealing a negative correlation between local incorporation and state size); Daines, *supra* note 11, at 1606 tbl. A2 (revealing a similar negative correlation in thirty states and the District of Columbia between size and percentage of firms incorporated locally).

small states is quite consistent with an politics-oriented interpretation of home state incorporation. The smaller the state in which a given firm is located, the larger the potential influence of the firm (or its managers or large shareholders) on local politics. Indeed, in a small state the company may have no effective competition for political influence; i.e., no competing interest groups on the relevant issues. In contrast, a large state may have a wide range of stakeholder interest groups, like labor, that offset the company's influence with the legislature. For example, California remains one of the few states never to have adopted an anti-takeover statute. (Consider, at the opposite end of the spectrum, California, where a substantial number of companies reincorporated out of state because the plaintiffs' bar successfully delayed the passage of manager-friendly amendments to the corporation code involving fiduciary duties.[24]) Small states are also likely to have the least developed bodies of corporation law, which is a disadvantage in terms of transaction costs but an advantage if a local firm wants a friendly local court to be relatively unconstrained in finding ways to rule in the firm's favor.

It follows that, in choosing its state of incorporation, a firm is choosing, in important part, between the market-oriented advantages of Delaware law and the politics-oriented advantages of home state law. Any other state would offer neither – and particularly not the politics-oriented advantages of home state incorporation – thus, a company would consider incorporation only in its home state or in Delaware.

It further follows that the market-oriented service that Delaware offers to companies is largely inconsistent with the type of service offered by the politics-oriented law of other states. Delaware's market-oriented law would not survive in a politics-oriented environment, and a politics-oriented environment would not produce market-oriented corporate law. It is this divergence that yields an important degree of complementarity between the corporate law of Delaware and the corporate law of other states. If the alternative of incorporating in Delaware

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[24] The amendment involved exemption of corporate directors and managers from personal liability for damages resulting from their breach of the duty of care – a provision modeled on Delaware's previously adopted addition of section 102(b)(7) to its General Corporation Law. *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 66 (1989) (arguing that half of their sample of firms that reincorporated in Delaware in order to take advantage of § 102(b)(7) came from California, whose counterpart rule did not become effective until more than a year later).

were not available to corporations headquartered in other states, then those corporations – or corporate stakeholders – that prefer market-oriented law would lobby much more strongly for their home state to reform its corporation law in that direction, and make it less congenial to parochial interests. That is, with the opportunity of exit denied to them, their voice would become louder with respect to the making of home-state corporate law. And the result, presumably, would be more market-oriented law in most states, though not quite so market-oriented as Delaware law has become.

Conversely, as we have noted, Delaware law has become more market-oriented than the law of other states in important part because it is largely free of influential lobbying by corporate stakeholders. If all U.S. corporations were required to incorporate under Delaware law – or if, more plausibly, basic corporation law were to be nationalized under a single federal corporation statute – then Delaware (or the federal government) would presumably become the focus of much more intense lobbying by various corporate stakeholders, with the result that it would become less market-oriented and more politics-oriented.[25] Scholars who view the U.S. rule of free incorporation as producing regulatory competition, whether for the better or for the worse, typically seem to assume that the various states are competing for the same corporations, and that those corporations are looking for the same attributes in corporation law. The view that we offer here, instead, offers more or less the opposite interpretation. The corporations that choose Delaware are seeking something different from corporation law than are those corporations that choose to incorporate in their home state. As a consequence, Delaware is largely free to pursue its natural advantage in offering market-oriented corporate law, unburdened by the need to appease corporate constituencies seeking other types of law. At the same time, the availability of Delaware's market-oriented corporate law gives to states other than Delaware much more freedom to design and administer their corporate laws in response to the desires of important local constituencies. In sum, Delaware corporate law seems best viewed as a complement to the corporate law offered by other states, rather than as a competitor.

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[25] Romano, *supra* note 6, at 25.

This is not to suggest that there is no competition at all between Delaware and other states for corporate chartering. A given company might see advantages both in having political influence with government and in being governed by market-oriented corporation law. The difficulty is that these two things are in large part incompatible; each company must choose one or the other.[26] That choice may nevertheless be a very close one for some firms. And it is presumably at this margin, where some number of companies is close to indifference between the advantages of incorporating in their home state and the (very different) advantages of incorporating in Delaware, that Delaware is in close competition for corporate charters. As we have already suggested, however, that competition may create incentives for greater differentiation between the corporate law of Delaware and that of other states, not for greater homogeneity. Delaware is offering corporate chartering with different attributes from that offered by companies' home states, and the greater that difference the more charters they may be able to obtain. Conversely, states other than Delaware have an incentive – if they wish to have local firms chartered in the state – to differentiate their corporate law regime from that of Delaware, and not to imitate Delaware.

Delaware has established a near-monopoly on market-oriented corporate law. No other state is making an active effort to attract chartering of out-of-state firms by offering market-oriented corporate law. This monopoly evidently derives from the characteristics of Delaware that we have mentioned before: the state's uniquely small size and low level of industrialization; the network effects of having firms in a market share common attributes; the self-reinforcing effects of having a large body of precedent and experienced courts; and the first mover advantage on which these other advantages build. Since Delaware is clearly in the corporate chartering business for the sake of net state revenue and the private activities, like law firms, associated with it, this might suggest that Delaware can get away with extremely high chartering fees and inefficiently low supply of market-oriented corporate law. But Delaware is

[26] One might at first think that a company could have it all – incorporate in Delaware, but exercise political influence through the location of production facilities in the state whose law the company wanted to influence. To some extent, the strategy is commonplace – almost every Delaware company has its production facilities in another state, and nothing limits the company from exercising influence over other than corporate law in the production state. However, it remains disabled from influencing the corporate law governing its activities.

not the only state with market power when it comes to incorporation. Each state in the union has an effective monopoly on politics-oriented corporate law within its borders. Companies headquartered in a given state generally cannot be offered politics-oriented law by some other state. A company headquartered in Illinois, for example, is unlikely to increase its political influence by reincorporating in Ohio unless it moves its corporate headquarters to Ohio as well, and this makes Ohio rather than Illinois its home state. As a consequence, Delaware is engaged in duopolistic competition with each of the other states. Since Delaware cannot constitutionally engage in price discrimination with respect to a company's home state, it has an incentive to pick a schedule of franchise fees that maximizes the aggregate income it derives from all of these individual duopolies. Thus regulatory dualism in a federal system of corporate chartering need not necessarily result in a single-state monopoly on market-oriented law, though some degree of market power is probably unavoidable.

Would corporate law in the United States be more efficient, overall, if it had adhered to the real seat doctrine rather than free incorporation? It is hard to say. Viewed as regulatory dualism, the opportunity for corporations to have access to the market-oriented law of Delaware comes at the cost of allowing substantive corporate law in all other states to become less efficient. It is not possible, then, to say *a priori* which regime would be best. Some evidence in favor of free incorporation can, however, be seen in the U.S. experience with banking. In contrast to other types of corporations, banks were subject to a strong version of the real seat doctrine from the nation's founding until 1986. And the result is commonly viewed as underdevelopment in U.S. banking so severe as to impel precocious development of the nation's equity markets.

Our analysis so far has ignored the state of Nevada, which is the only state other than Delaware that has made a serious – and partly successful – effort to become the chartering jurisdiction for companies headquartered in other states. As with Delaware, Nevada's motive appears to be income for the state treasury via franchise fees. Nevada, however, offers substantive corporate law with a character rather different from that of Delaware law. Most conspicuously, Nevada law appears to minimize the fiduciary duties of corporate directors and officers to the firm and its shareholders. Rather than offering protection to noncontrolling shareholders, Nevada law appears to be offering protection to managers and controlling shareholders. We might therefore characterize Nevada law as *controller-oriented*, in contrast to the market-oriented law of Delaware.

There are two alternative interpretations of Nevada's activity. The first is that Nevada's law is effectively the opposite of Delaware's: it is designed to attract companies whose controlling shareholders or managers are in essence seeking greater latitude to exploit noncontrolling shareholders. In our analysis, this sets up a three-way choice in chartering corporations: "good" substantive corporate law (Delaware); "bad" substantive corporate law (Nevada); and political influence with less regard for the current substantive content of corporate law (the other 48 states). The result is regulatory dualism that runs in two directions. First, there is dualism between Nevada and the other 48 states. The presence of Nevada presumably draws off some of the pressure on the other states to provide controller-oriented corporate law, improving the efficiency of the law in those states. In turn, Delaware might itself be pressed to offer even more market-oriented corporate law. Again, it is difficult to say a priori whether the results can be expected to be positive or negative for overall efficiency. But, when viewed from the perspective of regulatory dualism, Nevada's provision of inefficient controller-oriented corporate law could actually lead to greater overall efficiency in corporate chartering.

We want to be cautious, however, in characterizing Nevada corporate law as permitting inefficient exploitation of non-controlling shareholders.[27] The optimal degree of autonomy for

[27] K.J. Martin Cremers & Simone M. Sepe, *Whither Delaware? Limited Commitment and the Financial Value of Corporate Law*, working paper, available at http://ssrn.com/abstract=2519238 (Nov. 2013), argue that Nevada (as well as certain other states that provide greater anti-takeover protection than Delaware) allow companies to make long-term credible commitments to contractual parties that facilitate contracting with respect to long-horizon projects or where the counterparty must make relationship specific investments in performance. They report that companies with these characteristics show statistically significant positive increases in Tobin's Q following reincorporation from Delaware to one of the more protectionist states. Put in our terms, these states may present a third pattern of corporate law and we might then speak about tri-regulation. We remain, however, unpersuaded by this quite inventive paper. First, we are skeptical that reincorporating to Nevada is in fact a powerful signal of commitment to a long investment horizon. Reincorporating from Delaware to Nevada to the end of increasing antitakeover defenses requires a shareholder vote. If the company can secure a shareholder vote to reincorporate

managers or controlling shareholders remains subject to dispute. Moreover, reincorporation in Nevada requires a shareholder vote (including, perhaps, a majority of the minority where there is a controlling shareholder), and with the advent of large institutional shareholdings a vote of approval for shareholder-exploitative reincorporation may be difficult to obtain. Thus, Nevada's recent entry into the business of chartering corporations headquartered elsewhere might be seen as regulatory competition with respect to Delaware and, with respect to all the other states, an added element of regulatory dualism.

The natural alternative to regulatory dualism in corporate chartering is a single body of corporate law that is homogeneous across the nation. One potential means to this end, which has been successful in other areas of law such as commercial contracting, is for the individual states to adopt a common model act. This approach has, however, already been tried and failed. That failure, itself, may have come about because, by the time it was tried, regulatory dualism had already had the effect of inducing most states to offer politics-oriented law, and the locally-chartered corporations that benefited from that law had sufficient political influence in their home states to prevent its abandonment in favor of a nationally uniform regime less responsive to local interests.

The other obvious approach to nationally uniform corporation law is -- as noted in our introductory paragraph -- federal chartering that would preempt and displace incorporation at the state level. If the U.S. regime of free incorporation were characterized only by regulatory competition, and not by regulatory dualism, then federal chartering might well be expected to be more politics-oriented, and consequently less efficient, then the current system of free

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presumably it could also secure a shareholder vote to amend the charter to more directly prevent takeovers. Second, the signal of a long investment horizon by selecting Nevada incorporation is particularly noisy. Nevada law also allows eliminating fiduciary duty entirely, including the duty of loyalty (Delaware does not allow ordinary corporations to contracting out of the duty of loyalty), thereby confusing the reincorporation signal by reducing the constraints on managerial and controlling shareholder self-dealing. Michal Baruza & David C. Smith, *What Happens in Nevada? Self-Selecting into Law Law*, 27 Rev. Fin. Stud. 3953 (2014). Finally, Cremers & Sepe's measure of antitakeover protection depends importantly on the proposition that state antitakeover statutes provide effective protection. We note that Emiliano Catan & Marcel Kahan, *The Law and Finance of Anti-takeover Statutes*, ECGI Law Working Paper No. 274/2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2517594, raise challenging questions as to whether the failure to understand the institutional framework of such statutes renders unreliable the empirical literature that is typically relied upon to show that they matter.

incorporation. If, however, free incorporation has led to a substantial degree of regulatory dualism, as we have suggested here, then it is less apparent that federal chartering would be less market-oriented than the currently prevailing regime.

Of course, the U.S. does not really have a pure system of free incorporation. Rather, significant aspects of corporation law have gradually been nationalized over the past 80 years. This has taken place largely through securities regulation, which has targeted those aspects of corporate law that most affect the viability and efficiency of a national market for corporate securities. Viewed in terms of regulatory dualism, this should increase the relative advantage of home-state incorporation over Delaware incorporation, since federal law now supplies some of the market-oriented advantages previously offered by Delaware.

In the United States, the choice of law rules for corporate chartering, and the resulting pattern of regulatory dualism between Delaware and the other states, were not adopted self-consciously as a matter of policy. The natural alternative, in the early days of the Republic, was the real seat doctrine that has prevailed in Europe. As we have noted, the latter rule in fact prevailed for U.S. banks until 1986, making it clear that there was nothing inherent in U.S. law to keep the states from adopting the real seat doctrine for business corporations in general. (Indeed the reverse pattern might have made more sense in economic terms, with banks required to have a federal charter and other business corporations subjected to the real seat doctrine.) Free incorporation seems to have evolved by happenstance. And with that rule came, from the late 19th century onward, regulatory dualism. But perhaps regulatory dualism itself is not quite such a matter of happenstance. Explicitly or implicitly, courts and legislatures may have understood the benefits – or at least the political benefits – of regulatory dualism, and this may have aided the survival of both regulatory dualism and the free incorporation doctrine that permits it.

But survival is not necessarily an indication of efficiency. Moreover, today the alternative to regulatory dualism is not the real seat doctrine but rather nationalization of corporation law -- federalization in the terms of the U.S. debate and "harmonization" in EU terms. And it is not obvious which of these two regimes promises greater social welfare given the existing political constraints. We can only say here that, in assessing the relevant costs and benefits, it is well to understand that the benefits of the current system of state-level incorporation may lie less in hypothetical regulatory competition than in the quite different phenomenon of regulatory dualism.

III. EU Corporate Law: Harmonization or Heterogeneity?

In the previous section, we showed that providing corporations free choice of state of incorporation results in more than the simple regulatory competition phenomenon that has dominated the corporate chartering discourse in the United States. When corporations are heterogeneous in their preferences for a corporate law regime, choice of incorporation can result in a separating equilibrium that allows corporations to make observable their type. In the U.S, we argued, some corporations favor a corporate law that stresses fair treatment of public shareholders, and so reduces the corporation's cost of equity capital by credibly committing to a protective corporate law,[28] a pattern that reflects the favorable view of regulatory competition as set out in the standard discourse. Other corporations, however, favor corporate law that is more responsive to local political influence, leading to a preference for incorporating (or remaining incorporated) in the jurisdiction where the corporation has the greatest political influence. As we have seen, the U.S. experience is consistent with this picture of dual regulation: somewhat more than half of large public corporations choose Delaware incorporation and somewhat less than half choose home state incorporation. As we have shown, the dual systems are complementary. It is difficult to imagine a single regime that satisfies both preferences as well as specialized regimes; the presence of each regime allows the other to function more effectively by reducing the pressure to address two conflicting strategies.

This reframing of the U.S. debate over free incorporation beyond regulatory competition holds lessons for the European context as well. Recent developments in EU law

[28] *See*, *e.g.*, Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, ECGI Law Working Paper No. 216/2014, http://ssrn.com/abstract=2182781.

that move the EU away from the real seat doctrine and toward free incorporation have spurred a significant debate over regulatory competition, framed by and drawing heavily on the U.S. literature and experience. The EU debate is both more vibrant than in the US, because it involves issues currently being addressed at the EU level, and more complex, because in the EU context the free chartering debate involves two dimensions, rather than the single dimension in the U.S.: a choice among the corporate law offered by member states, and the choice of incorporating at the EU level.

At the member state level, the groundbreaking 1999 decision by the European Court of Justice in *Centros*[29] – later followed in *Überseering* (2002)[30] and *Inspire Art* (2003)[31] – effectively abandoned the real seat doctrine in favor of free incorporation: corporations are free to organize in any EU state and establish their business in any other. This gave European entrepreneurs and managers for the first time the ability to opt out of their home country's corporate governance rules in favor of those of any other member state that seem favorable. In *Centros* itself, United Kingdom incorporation was chosen for a private Danish business because the Denmark's required minimum capital contribution was significantly higher than that of the UK, a clear example of regulatory competition.

At the EU level, the establishment of the European Company (*Societas Europaea* – SE) in 2001[32] further expanded the existing menu of organizations available to entrepreneurs, providing another corporate regime in addition to that provided by each of the member states. Commentators described the creation of the SE, an organizational form provided at the federal EU level, as promoting "vertical competition"[33] – between the corporate law of each member state and that now provided by the SE directive – as opposed to the horizontal competition prevailing among the different states since *Centros*.

[29] Case C-212/97, Centros Ltd. v. Erhervs- og Selskabsstyrelsen, 1999 E.C.R. I-1484.
[30] Case C-208/00 Überseering BV v Nordic Construction Company Baumanagement GmbH [2002] ECR I-9919.
[31] Case C-167/01 Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd [2003] ECR I-10155.
[32] Council Regulation 2157/2001, 2001 O.J. (L 294) 1 (EC); Council Directive 2001/86, 2001 O.J. (L 294) 22 (EC).
[33] *See*, *e.g.*, Jodie A. Kirshner, *Empirical Notes on the Societas Europaea*, *in* COMPANY LAW AND ECONOMIC PROTECTIONISM: NEW CHALLENGES TO EUROPEAN INTEGRATION 351 (Ulf Bernitz & Wolf-Georg Ringe eds., 2010).

Yet the EU experience carries strong elements of regulatory dualism and the potential for complementary rather than purely competitive corporate law regimes. The standard regulatory competition story, where states (and the federal level) compete to provide a similar product, downplays the fundamental political tension in a federal system: local interests can conflict with federal interests, as we saw in the US with respect to takeover regulation. In the US, individual states sought to protect local corporations as evidenced most powerfully by state-level anti-takeover legislation, while for a period of time, the federal government actively favored a vigorous market for corporate control because of macroeconomic benefits. The same tension appeared in the EU, where the original draft of the Takeover directive sharply limited member state barriers to takeovers, only to see the directive rejected by the European Parliament in a close vote, leaving the member states considerable discretion to protect local corporations. *Centros* and its progeny, as well as the development of the SE at the EU level, can be viewed as mechanisms to diffuse this tension by giving local firms that prefer a market oriented corporate law an alternative to restrictive local law should a jurisdiction offer that regime.

By permitting corporations to incorporate in a foreign member state and to be governed by that state's corporate laws, *Centros* can allow firms to escape inefficient home state laws shaped by local political interests. A prominent consequence of *Centros* is to permit new German firms to incorporate elsewhere (usually in the UK) and thereby avoid the future incidence of employee board representation ("codetermination"). Meanwhile, codetermination levels at existing firms that are of substantial political consequence to German unions remain protected, due to the difficulties in relocating the state of incorporation, via merger or otherwise. While the repeal of codetermination is not politically feasible in Germany at present, *Centros* allowed new German firms – for example, new technology firms -- to escape it entirely, hence potentially eliminating an interest group likely to push for future reform. In this way, the choice of state of incorporation enabled by *Centros* could be viewed as complementary, rather than detrimental to, the survival of codetermination in Germany.

Beyond the greater choice at the state level provided by *Centros*, the EU also moved to offer a corporate form of its own – the SE. Like *Centros*, the SE upholds (roughly) present codetermination requirements for existing firms that are already subject to its requirements, but permits small and new companies to avoid greater (or any) employee participation in the future. That is, the applicable regulation and directive effectively freeze existing codetermination requirements as of the time the SE is formed. This means that a German company with fewer than 500 employees that becomes an SE will never be subject to codetermination, while a company that has between 500 and 2,000 employees at the time it becomes an SE will have employee board participation fixed forever at one-third of the company's board – regardless of future growth in the number of employees.. Only companies that already have more than 2,000 employees must retain the maximum level of quasi-parity (i.e., 50%) employee representation at the supervisory board.[34] There is evidence that German companies have opted for the SE form precisely to avoid future increases in codetermination levels.[35]

As with the judicially imposed *Centros* regulatory dualism regime with respect to corporate chartering, the dualism elements of the EU level SE regime serves to allow new firms to choose to be free of codetermination, but leaves existing firms already subject to codetermination – in effect, the unions' installed base – with only the ability to negotiate the terms of that relationship but not to unilaterally avoid it. In both cases, the new economy is given the right to opt out of codetermination, but the old industrial economy remains subject to the existing political arrangement.

While *Centros* and the availability of the SE regime created regulatory dualism in corporate chartering at both the member state and the EU level, the effects of the effort have been starkly different than in the U.S. Regulatory dualism in the US has resulted in a roughly even split between the market-oriented corporate law regime reflected in Delaware law and the politics-oriented regimes located in most other states. As we have seen, Delaware law is

[34] For a more detailed discussion, *see* Gilson et al., *supra* note 1, at 510-511.

[35] Horst Eidenmüller et al., *Incorporating Under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage*, 10 EUR. BUS. ORG. L. REV. 1 (2009)

structurally and substantively protected from political influence: statutory reform is driven by the Delaware corporate law bar, and significant judicial reform and updating is largely a function of the application of broad standards like fiduciary duty applied by expert, experienced courts that also are largely isolated from political influence.[36] In contrast, we have seen evidence that state courts and legislatures, especially in small states, are responsive to the interests of local firms.

The impact of regulatory dualism in the EU corporate chartering regime is far more limited; at most it has been largely incremental rather than transformational. Rather than half of public corporations selecting a single jurisdiction, there has been no large-scale movement in incorporation choice, other than an initial flurry of (mostly German) private companies choosing UK incorporation, a phenomenon that soon dissipated. Scholars view the decline in UK chartering by German firms as due, at least in part, to legal changes reducing or eliminating minimum capital requirements to appease local start-ups – in order words, as a result of regulatory competition.[37] The facts, however, complicate the story: the decline in UK incorporations by non-UK firms actually preceded Germany's reduction of capital requirements in response to *Centros*. In view of this, other studies have attributed the renewed preference for local chartering to an initial underestimation of the transaction and compliances costs associated UK chartering, as well as to the negative image that came to be connected with out-of-state chartering to circumvent local requirements.[38] The result seems to reflect both the limited advantage of UK foreign incorporation for non-UK companies, and the greater costs associated with it. For example, public corporations and venture capital-funded startups have little need to avoid minimum capital requirements that, while large for a small business, are of

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[36] *See* Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 14–17 (2006); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. Rev. 757, 845–47 (1995); Gilson, Sabel & Scot, supra note 10, at 845-47.

[37] *See*, *e.g.*, William Bratton, Joseph McCahery & Erik Vermeulen, *How Does Corporate Mobility Affect Lawmaking? A Comparative Analysis*, 57 AM. J. COMP. L. 347 (2009); Martina Eckardt & Wolfgang Kerber, *Developing Two-tiered Regulatory Competition in EU Corporate Law: Assessing the Impact of the Societas Privata Europaea* 41 J. L. & SOC'Y 152, 163-4 (2014)

[38] *See*, *e.g.*, Wolf-Georg Ringe, *Corporate Mobility in the European Union – A Flash in the Pan? An Empirical Study on the Success of Lawmaking and Regulatory Competition*, 10 EUR. COMPANY & FIN. L. REV. 230 (2013).

little consequence for more substantial commercial efforts; there was simply no compelling case for foreign incorporation.

Similarly, the attraction of the SE has been relatively modest, and mostly driven by firms from countries that have codetermination requirements.[39] As of early 2014, there were over 2,000 SE incorporations, of which approximately 75% came from the Czech Republic and nearly 15% from Germany.[40] However, this description significantly overstates the attraction of the SE form. The overwhelming majority of Czech SE incorporations were not companies with significant operations, but rather shelf or "UFO" companies formed by lawyers in anticipation of (still not materialized) future market demand.[41] More generally, only 169 of the roughly 700 SEs formed between 2004 and 2011 had actual business activities and more than five employees.[42] The large-scale adoption of the SE is also hampered by its obvious focus on larger enterprises: the minimum capital requirement of EUR 120,000 makes it unsuitable for small and medium enterprises (SMEs). Nevertheless, efforts at creating a European corporate form tailored to SMEs – the *Societas Privata Europaea* (SPE) – has halted due to the inability to reach compromise on key issues such as codetermination as well as the unfavorable balance between the costs of the SE form and the benefits. The compromise solution that was feasible for the SE was no longer acceptable for an organizational form of wider reach.[43]

Scholars have cited a number of factors to explain why incorporations in foreign member states or as SEs remain limited, ranging from language barriers and the commercial interests of local lawyers in retaining an important part of their practice, to concerns about

[39] Lars Hornuf & Julia Lindner, *End of Regulatory Competition in European Company Law?*, Andrássy Working Paper Series No. 33 (2014), http://ssrn.com/abstract=2494309.
[40] *Id.*
[41] Horst Eidenmueller & Jan Lasak, *The Czech Societas Europaea Puzzle*, ECGI Law Working Paper No. 183/2011, http://ssrn.com/abstract=1969215. A SE is identified as UFO ("unidentified flying object) if it is "probably operating," for which there is some information available on the commercial registry but no data on the number of employees. *Id.*
[42] Horst Eidenmüller, Lars Hornuf & Markus Reps, *Contracting Employee Involvement: An Analysis of Bargaining Over Employee Involvement Rules for a Societas Europaea*, ECGI Law Working Paper No. 185/2012, http://ssrn.com/abstract=1979487.
[43] Peter Hommelhoff & Christoph Teiuchmann, *Societas Privata Europaea (SPE) – General Report*, *in* THE EUROPEAN PRIVATE COMPANY - SOCIETAS PRIVATA EUROPAEA (SPE) (Heribert Hirte and Christoph Christoph eds., 2012).

undesirable future legal developments in foreign jurisdictions.[44] But the primary obstacle seems to be the absence of a member state specialized in providing market-oriented law of sufficiently high quality to outweigh the local law bias and the costs of distant incorporation. There is still no European-equivalent of Delaware – that is, a state with the proper incentives and ability to specialize in the production of market-oriented corporate law – although the UK and the Netherlands arguably come closest.[45] (Little Luxembourg, with a population of only about 500,000, might seem a candidate to be the Delaware of Europe, but has arguably become too reliant on its banking industry to play that role credibly.) Nor does the SE provide a sufficiently enticing alternative for most European firms, for it is very thin in terms of corporate *law*. Owing to the political compromise that eventually permitted the establishment of the SE, a nontrivial share of its internal affairs rules piggyback on the law of the member state where the SE has its registered office.[46] Consequently, the SC retains a substantial element of the real seat doctrine: "there is not one supranational legal form but 28 different SEs."[47] Thus, there is little to offset the profound local and political pull toward the countries in which companies do their most important business and in which such companies may have significant influence with the legislature and courts.

Regulatory dualism, to be sure, is not the only solution to local resistance to market-oriented law in an integrated economy; the initial EU approach to securing a common body of corporate law that would support a single market was not to rely upon corporations choosing the best corporate law proffered by competing states. Rather, the commonality necessary to facilitate a single capital market in which shares could be traded without knowledge of each member state's corporate law was to be secured by an aggressive EU level harmonization of

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[44] *See*, *e.g.*, Jens Dammann, *Homogeneity Effects in Corporate Law*, 46 ARIZONA ST. L.J. (forthcoming) (reviewing the reasons offered for modest corporate mobility in Europe).
[45] *See* Adam Pritchard, *London as Delaware?*, 32 REGULATION 22 (2009) (arguing that although London shares some of Delaware's characteristics, its lesser insulation from politics makes it less attractive for incorporations); *Here, There, and Everywhere*, THE ECONOMIST, Feb. 22, 2014 (referring to the view that the Netherlands is emerging as "Europe's Delaware").
[46] SE Regulation. *See also* Jodie A. Kirshner, *A Third Way: Regional Restructuring and the Societas Europaea*, 7 EUR. COMPANY & FIN. L. Rev. 444 (2010) ("In order to reach an agreement, the European Member States compromised on a framework structure that harmonized only minimal amounts of company Law and left the rest to national law").
[47] Hornuf & Lindner, *supra* note 39.

corporate law across member states: a unitary rather than dual regulation approach. Harmonization would cover "all provisions concerning structure and organs of companies, formation and maintenance of its capital, the composition of the profit and loss account, the issue of securities, mergers, conversions, liquidations, guarantees required in cases of company concentrations, etc."[48] As has been recounted frequently, the momentum of harmonization slowed and its ambition shrunk, ultimately focusing more, as in the original shareholders rights directive, on facilitating cross border exercise of rights provided under member state law.[49] In all events, the retreat of the harmonization movement did not give rise to freedom of incorporation as an explicit strategy.[50] Indeed, scholars have argued that the system of corporate mobility promoted by *Centros* and its progeny were largely an accident, rather than the product of a desired vision for corporate law to substitute for the diminished harmonization effort.[51]

The Takeover Rights Directive provides another illustration of the difficulties in achieving meaningful harmonization of substantive corporate law rules. The Directive as proposed by the European Commission represented a very ambitious effort to dictate an important area of member state corporation law, especially with the Commission's proposals of the City Code

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[48] Jan Wouters, *European Company Law: Quo Vadis?*, 37 COMMON MKT. L. REV. 257, 268 (2000) (quoting from the Berkhouwer report of 1966).

[49] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies. An amendment to the proposed revision to the directive, which would require a mandatory timed voting system if the company chose it, seems a throwback to the earlier harmonization process, but appears to lack sufficient support to emerge from the European Parliament process. Steve Johnson & Sophia Grene, *EU Pushes ahead with Shareholder Rights Law despite Concerns*, F.T., Mar. 8, 2015.

[50] It is commonplace to note that the U.S. has its own harmonization process, with the same type of ebb and flow as the EU experience. Most explicitly, under the Securities Exchange Act of 1934, important elements of state public corporation law have been harmonized, especially the proxy system. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2006), surveys the waves of efforts at Federal harmonization of state corporate law. Most recently, an aggressive effort to explicitly harmonize much of state corporate law through Federal legislation arose in the early 1970s. *See* Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976). While the effort may seem quixotic in hindsight, the concern over the possibility gave rise to an American Law Institute restatement-like project, intended to set out the principles of corporate governance, which might shape such an effort. The result of the effort was to study the subject until the passage of time made the effort largely irrelevant. The study, Principles of Corporate Governance: Analysis and Recommendation (1994) took some 10 years to finish.

[51] Martin Gelter, *Centros, the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law*, ECGI Law Working Paper No. 287/2015, http://ssrn.com/abstract=2564765.

prohibition of defensive tactics by targets and a breakthrough rule with respect to certain mechanisms that would prevent shareholders with more votes than equity from using their voting power to block a hostile offer. While the Commission proposal came within a small number of votes of securing European parliament approval, the proposal as ultimately adopted was of significantly less scope. It contained binding provisions precisely in areas where the laws of member states had already converged, as in the adoption of a mandatory bid rule in the event of a transfer of control. With respect to provisions aimed at enabling a market for corporate control – such as the board neutrality rule and the breakthrough rule – the directive's success in achieving harmonization were far more modest, due to political opposition from member states. The Directive gave member states the right to opt out of both the board neutrality and the breakthrough rules, subject to a modest version of regulatory dualism: firms in states that had opted out could individually opt back into the Directive's bidder-friendly default.[52]

Nevertheless, it is too early to rule out the promise of regulatory dualism in the European context. One of us has argued that a dual regulatory strategy – providing for different default rules for newly-public and existing public companies – could help appease political opposition to a new and more efficient Takeover Directive.[53]

Moreover, the political dynamics underlying regulatory dualism can help shed light on recent developments, such as the eye-catching migration of Fiat Chrysler from Italy to the Netherlands. That move has been generally interpreted in terms of regulatory competition. Specifically, the relocation would permit the powerful Agnelli family to remain in control of Fiat Chrysler and avoid dilution by employing multi-voting "loyalty shares" – a mechanism that was available under Dutch law but prohibited under Italian law at the time. And indeed regulatory competition has some purchase in this context, given that Italy subsequently reformed its

[52] Guido Ferrarini & Geoffrey Miller, *A Simple Theory of Takeover Regulation in the United States and Europe*, 42 CORNELL INT'L L. J. 301 (2009).
[53] Luca Enriques, Ronald J. Gilson & Alessio Pacces, *The Case for an Unbiased Takeover Law (with an Application to the European Union)*, 4 HARV. BUS. L. REV. 85 (2014).

corporation statute to permit loyalty shares, apparently in response to the Chrysler Fiat migration.[54]

But given the traditional political clout of the Agnelli family, it is doubtful that it could not have convinced the Italian legislature (which proved to be quite amenable to relaxing existing constraints) to change the law so as to keep Fiat Chrysler in Italy in the first place had it wanted to. An alternative explanation is that the move aimed precisely at avoiding similar exercises of political power by controlling shareholders in the future – in an attempt to credibly commit to investors about the company's intention to respect their rights prior to a listing on the New York Stock Exchange. A reading of the U.S. prospectus is consistent with this view. It describes the Dutch N.V. as a "well-established, investor-friendly corporate form," and the Netherlands as a "*neutral* jurisdiction that is not identified with either of the historical jurisdictions of the largest businesses operated by the Group."[55]

IV. Conclusion: Regulatory Dualism and Federalism

In earlier work, we introduced the concept of regulatory dualism as a way of addressing what we called the Olson problem – the resistance of an established economic and political elite to growth-promoting reform because the reform, while increasing the size of the overall pie, threatened the size of the elite's piece. Regulatory dualism, by leaving intact the rules that influence the size of the piece held by the elite and so reducing their incentive to resist growth-promoting reform, allows the reform to move forward. Given the alternatives, regulatory dualism can offer an attractive compromise from the elites' standpoint, since it avoids the costs of trying to block all reform, dilutes the costs imposed upon them by otherwise sweeping legal

[54] *For* a discussion, *see* Marco Ventoruzzo, *The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat*, ECGI Law Working Paper No. 288/2015, http://ssrn.com/abstract_id=2574236.

[55] Preliminary Prospectus Subject to Amendment and Completion, dated July 3, 2014, Merger of Fiat S.P.A. with and into Fiat Investments N.V. to be renamed Fiat Chrysler Automobiles N.V.

changes, and reduces the political pressure for more comprehensive reform that will touch them directly.

In this article we extend the application of regulatory dualism to a different but related problem: the scope and character of competition for corporate charters. We saw that in the United States there appear to be two quite different corporate regimes. One, that of Delaware, is market oriented: it facilitates efficient corporate transactions and provides substantial protection for non-controlling shareholders. A second, which reflects most other states, is influence-oriented: it provides a legal regime that helps promote and entrench the powers of controlling shareholders or managers, including the power to exercise political influence over the development of both corporate and non-corporate law that bears on their company's activities. We argue that, rather than competing with each other, these regimes are complementary. Corporations can choose the regime they want, allowing each regime to specialize rather than having to balance corporations' conflicting demands in a single corporate law and surrounding institutions.

This analysis suggests a broader application for regulatory dualism. The technique provides a regime that accommodates two conflicting demands on the legal system. Thus far, the context in which we have examined regulatory dualism has involved conflicting demands at the same level of government – a horizontal conflict between states in contrast to a vertical conflict between states and the federal level. We close with the thought that regulatory dualism may have its most consequential application in mediating the tension inherent in federalism. Any federalist system confronts the tension between the centrifugal and centripetal forces of federalism: local interests drive the member states apart while the positive externalities associated with scale, say from establishing a single market, draw them together. Coming back to our original application of regulatory dualism to the incentives of elites to block growth inducing economic reform if it is disadvantageous to the elite, in a federal system local interests may be best served by blocking federal level reform that taken together will benefit all member states if it disadvantages a particular locality. Harmonization imposed at the federal level must confront local political opposition while forgoing harmonization loses the benefit of the scale economies associated with a single market.

The history of harmonization in both U.S. and E.U. corporate law reflects the shifting tradeoff between local and federal interests. Regulatory dualism – for example, federal level law that reduces barriers to shareholders exercising rights given at the member state level – may allow two complementary regulatory systems to operate and allow the boundary between them to move with circumstances. Thus, the deep logic of regulatory dualism – the ability to trade off conflicting preferences – may address a central feature of federalist systems.