other factors of production—as in partnerships of lawyers and other service professionals, or simply in the prototypical two-person partnership in which one partner supplies labor and the other capital. As a consequence, the business corporation is less flexible than the partnership in terms of assigning ownership. To be sure, with sufficient special contracting and manipulation of the form, ownership shares in a business corporation can be granted to contributors of labor or other factors of production, or in proportion to consumption of the firm's services. Moreover, as the corporate form has evolved, it has achieved greater flexibility in assigning ownership, either by permitting greater deviation from the default rules in the basic corporate form (e.g., through restrictions on share ownership or transfer), or by developing a separate and more adaptable form for close corporations. Nevertheless, the default rules of corporate law are generally designed for investor ownership, and deviation from this pattern can be awkward. The complex arrangements for sharing rights to earnings, assets, and control between entrepreneurs and investors in high-tech start-up firms offer a familiar example.[42]

Sometimes corporate law itself deviates from the assumption of investor ownership to permit or require that persons other than investors of capital—for example, creditors or employees—participate to some degree in either control or net earnings or both. Worker codetermination is a conspicuous example. The wisdom and means of providing for such non-investor participation in firms that are otherwise investor-owned remains one of the basic controversies in corporate law. We address this subject further in Chapter 4.

Most jurisdictions also have one or more statutory forms—such as the U.S. nonprofit corporation, the civil law foundation and association, and the UK company limited by guarantee—that provide for formation of nonprofit firms. These are firms in which no person may participate simultaneously in both the right to control and the right to residual earnings (which is to say, the firms have no owners). While nonprofit organizations, like cooperatives, are sometimes labelled 'corporations', however, they will not be within the specific focus of our attention here. Thus, when we use the term 'corporation' in this book, we refer only to the business corporation, and not to other types of incorporated entities. When there is potential for ambiguity, we will explicitly use the term 'business corporation' to make specific reference to the investor-owned company that is our principal focus.

1.3 Sources of Corporate Law

All jurisdictions with well-developed market economies have a least one core statute that establishes a basic corporate form with the five characteristics

[42] Stephen N. Kaplan and Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 Review of Economic Studies 281 (2003).

described above, and that is designed particularly to permit the formation of public corporations—that is, corporations with freely tradable shares. Nevertheless, corporate law as we understand it here generally extends well beyond the bounds of this core statute.

1.3.1 Special and partial corporate forms

First, major jurisdictions commonly have at least one distinct statutory form specialized for the formation of closed corporations. These forms—the French SARL, the German GmbH, the Italian Srl, the Japanese close corporation, the American close corporation and (more recent) limited liability company, and the UK private company[43]—typically exhibit all of the canonical features of the corporate form. They differ from open companies chiefly because their shares, though transferable at least in principle, are presumed—and in some cases required—not to trade freely in a public market. Sometimes these forms also permit departure from one of our five core characteristics—delegated management—by permitting elimination of the board in favor of direct management by shareholders.[44] The statutes creating these forms also commonly permit, and sometimes facilitate, special allocations of control, earnings rights, and rights to employment among shareholders that go beyond those permitted in the core public corporation statute.

Second, some jurisdictions have, in addition to these special closed corporation forms, *quasi*-corporate statutory forms that can be used to form business corporations with all of our five core characteristics, though some of these characteristics must be added by contract. One example is the limited liability partnership, which has been provided for recently in the law of the U.S. and some European jurisdictions. This form simply grafts limited liability onto the traditional general partnership. U.S. law now allows the partnership to have something close to strong form entity shielding (by limiting the rights of partners or their creditors to force liquidation).[45] Consequently, with appropriate governance provisions in the partnership agreement, it is effectively possible to create a closed corporation as a limited liability partnership.

Another example is offered by the U.S. statutory business trust. The statutory business trust provides for (unambiguous) strong form legal personality and limited liability, but leaves all elements of internal organization to be specified in the organization's governing instrument (charter), failing even to provide statutory default rules for most such matters.[46] With appropriate charter provisions, a

[43] In the case of the UK private company, the standard form is provided not by a separate statute, but by a range of provisions in a single statute with differential application to public and private companies.

[44] See *supra* note 37.

[45] See Hansmann, Kraakman and Squire, *supra* note 12, at 1391–4.

[46] It differs from the common law private trust, from which it evolved, principally in providing unambiguously for limited liability for the trust's beneficiaries even if they exercise control.

statutory business trust can be made the equivalent of a public corporation, with the trust's beneficiaries in the role of shareholders.

The analysis we offer in this book extends to all these special and quasi-corporate forms insofar as they display the five core corporate characteristics.

1.3.2 Other bodies of law

There are bodies of law that, at least in some jurisdictions, are embodied in statutes or decisional law that are separate from the core corporation statutes, and from the special and quasi-corporation statutes just described, but that are nonetheless concerned with particular core characteristics of the corporate form as we define them here. Insofar as they are so concerned, we view them functionally as part of corporate law.

To begin, the German law of groups, or *Konzernrecht,* qualifies limited liability and limits the discretion of boards of directors in corporations that are closely related through cross ownership, seeking to protect the creditors and minority shareholders of corporations with controlling shareholders. Although the *Konzernrecht*—described in more detail in Chapters 5 and 6—is embodied in statutory and decisional law that is formally distinct from the corporation statutes, it is clearly an integral part of German corporate law. Similarly, the statutory rules in many jurisdictions that require employee representation on a corporation's board of directors—such as, conspicuously, the German law of codetermination—qualify as elements of corporate law, even though they occasionally originate outside the principal corporate law statutes, because they impose a detailed structure of employee participation on the boards of directors of large corporations.

Securities laws in many jurisdictions, including conspicuously the U.S., have strong effects on corporate governance through rules mandating disclosure and sometimes, as well, regulating sale and resale of corporate securities, mergers and acquisitions, and corporate elections. Stock exchange rules, which can regulate numerous aspects of the internal affairs of exchange-listed firms, can also serve as an additional source of corporate law, as can other forms of self-regulation, such as the UK's City Code on Takeovers and Mergers.[47] These supplemental sources of law are necessarily part of the overall structure of corporate law, and we shall be concerned here with all of them.

[47] We term such self-regulation a source of 'law' in part because it is commonly supported, directly or indirectly, by law in the narrow sense. The self-regulatory authority of the American stock exchanges, for example, is both reinforced and constrained by the U.S. Securities Exchange Act and the administrative rules promulgated by the Securities and Exchange Commission under that Act. Similarly, the authority of the UK's Takeover Panel was supported indirectly until 2006 by the recognition that if its rulings were not observed, formal regulation would follow. Since 2006, it has been directly supported by formal statutory authority in 2006 (Part 28 Companies Act 2006 (UK)), and so is no longer, strictly speaking, 'self-regulatory'.

There are many constraints imposed on companies by bodies of law designed to serve objectives that are, in general, independent of the form taken by the organizations they affect. While we will not explore these bodies in general, we will sometimes discuss them where they are specifically tailored for the corporate form in ways that have important effects on corporate structure and conduct. Bankruptcy law—or 'insolvency law', as it is termed in some jurisdictions—is an example. Bankruptcy effects a shift in the ownership of the firm from one group of investors to another—from shareholders to creditors. By providing creditors with an ultimate sanction against defaulting firms, it casts a shadow over firms' relations with their creditors, and affects the extent to which creditors may need generalized protections in corporate law. We thus consider the role of bankruptcy law in Chapter 5. Tax law also affects directly the internal governance of corporations at various points; the U.S. denial of deductibility from corporate income, for tax purposes, of executive compensation in excess of $1 million unless it is in the form of incentive pay, discussed in Chapter 3, is a clear example.[48] And, beyond providing for board representation of employees, labor law in some countries—as emphasized in Chapter 4—involves employees or unions in the corporate decision-making process, as in requirements that works councils or other workers' organs be consulted prior to taking specified types of actions.

1.4 Law Versus Contract in Corporate Affairs

The relationships among the participants in a corporation are, to an important degree, contractual. The principal contract that binds them is the corporation's *charter* (or 'articles of association' or 'constitution', as it is termed in some jurisdictions). The charter sets out the basic terms of the relationship among the firm's shareholders, and between the shareholders and the firm's directors and other managers.[49] By explicit or implicit reference, the charter can also become part of the contract between the firm and its employees or creditors. Some or all of a corporation's shareholders may, in addition, be bound by one or more shareholders' agreements.

At the same time, corporations are the subject of the large body of law whose various sources we have just reviewed. That body of law is the principal focus of this book. Before examining the details of that law, however, we must address a fundamental—and surprisingly difficult—question: What role does this law play? As we have already seen, with the exception of legal personality, the defining elements of the corporate form could in theory be established simply by contract.

[48] § 162(m) Internal Revenue Code.

[49] The charter may be supplemented by a separate set of bylaws, which commonly govern less fundamental matters and are subject to different—generally more flexible—amendment rules than is the charter.

And the same is true of most of the other rules of law that we examine throughout this book. If those rules of law did not exist, the relationships they establish could still be created by means of contract, just by placing similar provisions in the organization's charter. This was, in fact, the approach taken by the numerous unincorporated joint stock companies formed in England during the 18th and early 19th centuries, before incorporation became widely available in 1844. Those companies obtained their legal personality from partnership and trust law, and created the rest of their corporate structure—including limited liability—by means of contract.[50] Why, then, do we today have, in every advanced economy, elaborate statutes providing numerous detailed rules for the internal governance of corporations?

1.4.1 Mandatory laws versus default provisions

In addressing this question, it is important to distinguish between legal provisions that are merely default rules, in the sense that they govern only if the parties do not explicitly provide for something different, and laws that are mandatory, leaving parties no option but to conform to them.[51]

A significant part of corporate law—more in some jurisdictions, less in others—consists of default provisions.[52] To this extent, corporate law simply offers a standard form contract that the parties can adopt, at their option, in whole or in part. A familiar advantage of such a legally provided standard form is that it simplifies contracting among the parties involved, requiring that they specify only those elements of their relationship that deviate from the standard terms. Corporate law's provision of such standard terms as default is thereby seen in economic terms as a 'public good'. Default provisions can serve this function best if they are 'majoritarian' in content—that is, if they reflect the terms that the majority of well-informed parties would themselves most commonly choose.[53]

Defaults can, however, also serve other functions, such as encouraging the revelation of information. For example, where one contracting party is likely to have superior information relevant to the transaction than is the other (or as economists say, that party has 'private information'), then a default provision may impose a burden, or 'penalty', on the informed party, with the understanding that the default may be waived by disclosure of the information. The purpose of such a rule is to encourage parties to reveal their private information—so that they can avoid the default outcome—and consequently induce explicit bargaining

[50] Ron Harris, Industrializing English Law (2000); Hansmann, Kraakman, and Squire, *supra* note 12.

[51] See generally the papers in the symposium edition, entitled *Contractual Freedom and Corporate Law*, in 89 Columbia Law Review 1395–1774 (1989).

[52] They are 'defaults' in the sense that they apply (as with computer settings) 'in *default*' of the parties stipulating something else.

[53] Easterbrook and Fischel, *supra* note 7, at 34–5.

between the parties that will lead to an outcome superior to that which would otherwise be expected.[54] Such a 'penalty default' may not be a majoritarian default.

Default provisions can be supplied in a variety of ways, the choice of which affects the ease and means of 'contracting around' them.[55] A common form of corporate law default is a statutory provision that will govern unless the parties explicitly provide an alternative. The common U.S. requirement that a merger can be approved by a vote of 50% of all outstanding shares is an example. That rule can be displaced by a charter provision that explicitly requires approval by, say, 60% of the shareholders, or 70%, or some other number.

Alternatively, corporate law itself sometimes specifies the rule that will govern if the default provision is not chosen—an 'either-or' provision. An example is offered by French corporate law, which allows companies' charters to opt for a two-tier board structure as an alternative to the default single-tier one.[56] In other words, the law in this case gives the corporation a choice between two statutory provisions, one of which is the default and the other of which is the 'secondary' provision, with the latter applying only if the firm opts out of the default (or, equivalently, 'opts in' to the secondary provision). The law may also impose special procedures for altering a default rule. For example, the law may impose a rule that is highly protective of non-controlling shareholders, and then permit deviation from that rule only with approval by a supermajority of all shareholders, or with separate approval by a majority of the non-controlling shareholders, thereby providing some assurance that the default rule will be altered only if the chosen alternative is superior for all shareholders.[57]

An extension of the binary two-alternative-provisions approach just described is to provide corporations with a choice among a 'menu' of more than two alternative statutorily-specified rules.[58] Although to date this approach is rarely taken within any given corporation statute,[59] it can in effect be seen in the increasing choice among alternative corporate forms, as we discuss below.

[54] See Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale Law Journal 87 (1989).

[55] The ease with which parties can 'contract around' a default provision will affect the way it operates. For example, if the costs of contracting around a provision are high, it may be less useful as an information-forcing 'penalty' default (although this will depend on the size of the 'penalty'), but still capable of functioning adequately as a 'majoritarian' default (as a majority of parties would prefer it anyway). For a nuanced discussion of these and other issues, see Ayres and Gertner, *supra* note 54, at 121–5. For an empirical perspective, see Yair Listokin, *What do Corporate Default Rules and Menus Do? An Empirical Examination*, Working Paper (2006), at http://www.ssrn.com.

[56] See Article 225–57 Code de commerce.

[57] On the latter consideration, see Lucian Bebchuk and Assaf Hamdani, *Optimal Defaults For Corporate Law Evolution*, 96 Northwestern University Law Review 489 (2002).

[58] Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 Virginia Law Review 757, 839–41 (1995).

[59] An exception is the UK's Companies Act 2006, which makes provision for multiple forms of model articles of association to be made available for different types of company: *id.*, § 19(2). Another is Italy's menu of three board systems: a default single-tier one with a separate body in

There are also important rules of corporate law that are mandatory.[60] Large German corporations, for example, have no alternative but to give half of their supervisory board seats to representatives of their employees, and publicly traded U.S. corporations have no alternative but to provide regular detailed financial disclosure in a closely prescribed format.[61] The principled rationale for mandatory terms of these types is usually based on some form of 'contracting failure': that some parties might otherwise be exploited because they are not well informed; that the interests of third parties might be affected; or that collective action problems (such as the notorious 'prisoners' dilemma') might otherwise lead to contractual provisions that are inefficient or unfair.[62] Mandatory terms may also serve a useful standardizing function, in circumstances (such as accounting rules) where the benefits of compliance increase if everyone adheres to the same provision.

Mandatory rules need not just serve a prescriptive function, however. When used in conjunction with a choice of corporate *forms*, they can perform an enabling function similar to that served by default rules. More particularly, mandatory rules can facilitate freedom of contract by helping corporate actors to signal the terms they offer and to bond themselves to those terms. The law accomplishes this by creating corporate forms that are to some degree inflexible (i.e., are subject to mandatory rules), but then permitting choice among different corporate forms.[63] There are two principal variants to this approach.

First, a given jurisdiction can provide for a menu of different standard form legal entities from which parties may choose in structuring an organization. In some U.S. jurisdictions, for example, a firm with the five basic attributes of the business corporation can be formed, alternatively, under a general business corporation statute, a close corporation statute, a limited liability company statute, a limited liability partnership statute, or a business trust statute—with each statute providing a somewhat different set of mandatory and default rules. Most conspicuously, the number of mandatory rules decreases as one moves from the first to the last of these statutory forms. The result is to enhance an entrepreneur's ability to signal, via her choice of form, the terms that the firm offers to other contracting parties, and to make credible the entrepreneur's commitment not to change those terms. Formation as a business corporation, for example, signals simply and clearly—to all who deal with the firm, whether by purchasing shares

charge of internal controls ('collegio sindacale'), a new single-tier system with no such separate body, and a two-tier system. See Article 2380, Civil Code.

[60] See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Columbia Law Review 1549 (1989).

[61] See *infra* 3.3.1 (codetermination) and 4.1.4 and 8.2 (disclosure).

[62] See generally Michael J. Trebilcock, The Limits of Freedom of Contract (1993).

[63] Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence From LLCs*, 73 Washington University Law Quarterly 369 (1995); John Armour and Michael J. Whincop, *An Economic Analysis of Shared Property in Partnership and Close Corporations Law*, 26 Journal of Corporation Law 983 (2001).

or simply by contract—that the firm is characterized by a variety of familiar governance provisions, and that it will continue to have those characteristics unless and until it changes statutory form.[64] Thus, paradoxically, greater rigidity within any particular form may actually enhance overall freedom of contract in structuring private enterprise, so long as there is a sufficiently broad range of alternative forms to choose from.

Second, even with respect to a particular type of legal entity, such as the publicly traded business corporation, the organizers of a firm may be permitted to choose among different jurisdictions' laws. This leads us to the general issue of 'regulatory competition' in corporation law. Before addressing that topic, however, we need to say more about the role of corporation law in general.

1.4.2 Legal rules versus contract

Default rules of corporate law do more than simply provide convenient standard forms, encourage revelation of information, and facilitate choice of the most efficient[65] among several alternative rules. They also provide a means of accommodating, over time, developments that cannot easily be foreseen at the outset.

A contract that, like a corporation's charter, must govern complex relationships over a long period of time, is—to use the word favored by economists—necessarily *incomplete*. Situations will arise for which the contract fails to provide clear guidance, either because the situation was not foreseeable at the time the contract was drafted or because the situation, though foreseeable, seemed too unlikely to justify the costs of making clear provision for it in the contract. Statutory amendments, administrative rulings, and judicial decisions can provide for such situations as they arise, either by adding new rules of corporation law or by interpreting existing rules. This is the *gap-filling* role of corporation law.

Courts can, of course, also fill gaps without making new law, simply by interpreting privately-drafted contractual terms in a corporation's charter. But a firm will get the greatest advantage from the courts' interpretive activity if the firm adopts standard charter terms used by many other firms, since those standard terms are likely to be subject to repeated interpretation by the courts.[66] And the most widely-used standard charter terms are often the default rules embodied in the corporation law. So another advantage of adopting default rules of law, rather than drafting specialized charter terms, is to take advantage of the constant gap-filling activity stimulated by the body of precedents developed as a result of other

[64] Third parties dealing with the firm can then ensure that no such change will occur by reserving a contractual veto on it, e.g. in the form of an acceleration clause in a loan agreement.

[65] Here, as elsewhere, we use the term 'efficient', as conventionally used in the economics literature, and as discussed below at 1.5, to refer to an organization of affairs that maximizes aggregate social welfare.

[66] Ian Ayres, *Making A Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 University of Chicago Law Review 1391, 1403–8 (1992).

corporations that are also subject to those rules. This is one example of a *network effect* that creates an incentive to choose a common approach.[67]

The problem of contractual incompleteness goes beyond mere gap-filling, however. Given the long lifespan of many corporations, it is likely that some of a firm's initial charter terms, no matter how carefully chosen, will become obsolete with the passage of time owing to changes in the economic and legal environment. Default rules of law have the feature that they are altered over time—by statutory amendments and by judicial interpretation—to adapt them to such changing circumstances. Consequently, by adopting a statutory default rule, a firm has a degree of assurance that the provision will not become anachronistic. If, in contrast, the firm puts in its charter a specially-drafted provision in place of the statutory default, only the firm itself can amend the provision when, over time, a change is called for. This runs into the problem that the firm's own mechanisms for charter amendment may be vetoed or hijacked by particular constituencies in order, respectively, to protect or further their partial interests. Simply adopting the statutory default rules, and delegating to the state the responsibility for altering those rules over time as circumstances change, avoids these latter problems.[68]

However, the quality and speed with which default rules are supplied, interpreted and updated will depend on a range of institutional variables concerning the legislative system, civil procedure, and judicial expertise. In the presence of poorly designed rules of civil procedure, judicial resolution of disputes over the interpretation of statutory provisions can also become a vehicle by which particular constituencies can protect or further their partial interests. Conversely, the design of the procedures for charter amendment will greatly influence the extent to which they can be used for the furtherance of partial interests, as opposed to fostering efficient change.

For example, in the U.S., Delaware, the leading state of incorporation for publicly traded corporations, has a 'rolling' default regime under which changes in default rules of law are applied to all corporations that do not have explicitly inconsistent terms in their charters. One indication that these statutory default rules successfully play a role of 'delegated (re)contracting', is the striking rarity with which U.S. publicly traded corporations deviate from their provisions. It is rare for a U.S. publicly traded corporation to include, in its charter, a provision that is not clearly specified as a default rule in the statutory law of the state in

[67] A related network effect that may encourage firms to adopt standardized charter terms, and in particular to accept default rules of law, is that those provisions are more familiar to analysts and investors, thus reducing their costs of evaluating the firm as an investment. Similar network effects may cause legal services to be less expensive for firms that adopt default rules of law. See Marcel Kahan and Michael Klausner, *Standardization and Innovation In Corporate Contracting (or 'The Economics of Boilerplate')*, 83 Virginia Law Review 713 (1997).

[68] See Henry Hansmann, *Corporation and Contract*, 8 American Law and Economics Review 1 (2006).

which the firm is incorporated.[69] In contrast, in the UK, the 'model' articles of association provided by the companies legislation apply on a 'fixed' basis, so that changes to the model provisions do not automatically update the articles of association of companies formed under the previous provisions.[70] Concomitantly, rates of 'opt out' from the UK's model provisions seem to be quite high.[71] However, alteration of the articles of association for a UK company is a more straightforward procedure than for a Delaware-incorporated firm.[72]

It follows from much of the foregoing that, for many corporations, there may often be little practical difference between mandatory and default rules. Firms end up, as a practical matter, adopting default rules as well as the mandatory rules. This suggests that there may be more scope for introducing flexibility into firms' choice of structure through the provision of menus of alternative default rules. There is arguably room for further development of this approach, with corporation statutes providing richer menus of alternative default terms for various aspects of corporate governance, all of which are (re)interpreted and amended over time to keep them current. At present, however, the closest that the law comes to such a menu approach lies in the abilities of participants to select from a range of different business forms—which we have discussed—and of corporations to choose the jurisdiction by whose corporation law they will be governed, which is the subject to which we turn next.

1.4.3 Regulatory competition

The various forms of flexibility in corporate law on which we have so far concentrated—the choice of specially-drafted charter provisions versus default provisions, the choice of one default rule in a given statute as opposed to another, and the choice of one statutory form versus another—can all be provided within any given jurisdiction. As we have noted, however, there can be yet another dimension of choice—namely, choice of the jurisdiction in which to incorporate.

In the United States, for example, the prevailing choice of law rule for corporate law is the 'place of incorporation' rule, which permits a business corporation to be incorporated under—and hence governed by—the law of any of the 50

[69] See Listokin, *supra* note 55. The position regarding close corporations is more varied. Many of these have highly specialized charters—arguably reflecting the greater ease of efficiently renegotiating the corporate structure among the small number of parties involved and the fact that structural changes are likely to occur anyway as the firm (hopefully) evolves from a start-up to a listed company.

[70] §§ 19(4), 20(2) Companies Act 2006 (UK).

[71] See Richard C. Nolan, *The Continuing Evolution of Shareholder Governance*, 65 Cambridge Law Journal 92, 115–19 (2006).

[72] In the UK, this is a decision purely for the shareholders, albeit requiring a supermajority vote (75%) (§§ 21and 283 Companies Act 2006 (UK)), whereas in Delaware, a charter amendment must first be proposed by the board, prior to a shareholder vote (§ 242(b) Delaware General Corporation Law).

individual states (or any foreign country), regardless of where the firm's principal place of business, or other assets and activities, are located. Where, as in the U.S., such choice is available at low cost, a given jurisdiction's corporation statute simply serves as an item on a menu of alternative standard forms available to the parties involved. As in the case where there is intra-jurisdictional choice of alternative forms, mandatory rules in any given jurisdiction's corporation law may serve not to constrain choice of form but actually to enhance it, by making it easier for firms to signal, and to bond themselves to, their choice among alternative attributes.

That form of choice, long available within the United States and in a number of other countries as well, is now being extended to corporations throughout the European Union as a consequence of recent decisions of the European Court of Justice that have largely substituted the place of incorporation rule for the 'real seat' doctrine under which, in many European countries, firms were formerly required to incorporate under the law of the state where the firm had its principal place of business.[73]

The consequence of choice across jurisdictions is not just to enlarge the range of governance rules from which a given firm can choose, but also to create the opportunity and the incentive for a jurisdiction to induce firms to incorporate under its law—and thereby bring revenue to the state directly (through franchise fees) and indirectly (through increased demand for local services) by making the jurisdictions' corporate law unusually attractive. Whether such 'regulatory competition' is good or bad has been the subject of vigorous debate. Pessimists argue that it creates a 'race to the bottom' in which the state that wins is that which goes furthest in stripping its law of protections for constituencies who do not control the reincorporation decision. Optimists argue that, on the contrary, regulatory competition in corporate law creates a virtuous 'race to the top' in which—because the capital markets price, more or less accurately, the effects of corporate law on shareholder welfare—the state that wins is that whose law is most effective in protecting the rights of shareholders and other corporate constituencies.[74]

[73] Case C-212/97, *Centros Ltd v. Erhvervs-og Selskabssyrelsen* [1999] ECR I-1459; Case C-208/00, *Überseering BV v. Nordic Construction Company Baumanagement GmbH* (NCC) [2002] ECR I-9919; Case C-167/01, *Kamel van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd* [2003] ECR I-10155; Case C-210/06, *Cartesio Oktató és Szolgáltató bt*, Judgment of 16 December 2008. See Jens C. Dammann, *Freedom of Choice in European Company Law*, 29 Yale Journal of International Law 477 (2004); John Armour, *Who Should Make Corporate Law: EC Legislation versus Regulatory Competition*, 48 Current Legal Problems 369 (2005); Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law*, 5 Journal of Corporate Law Studies 1 (2005).

[74] The classical statements of the two polar views are William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale Law Journal 663 (1974), and Ralph Winter, *State Law, Shareholder Protection and the Theory of the Corporation*, 6 Journal of Legal Studies 251 (1977). The extensive subsequent literature has debated whether in fact states compete for corporate charters, see Marcel Kahan and Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stanford Law Review 679 (2002), whether any competition that does exist leads to law that is better or worse for shareholders, see Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 Journal of Law Economics and Organization 225, 280–1 (1985); Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harvard Law Review 1435, 1441 (1992); and William Carney and George Shepherd, *The Mystery of the Success of Delaware Law*, University of Illinois Law Review 1 (2009), and, if competition leads to more valuable firms, what is the amount of increased value, *see* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 Journal of Financial Economics 525 (2001), and Guhan Subramanian, *The Disappearing Delaware Effect*, 20 Journal of Law Economics and Organization 32 (2004).

Clearly, the process by which reincorporation is effected will also be an important factor in determining the nature of any such 'race'.[75] The more inclusive the process of parties involved in the firm, the less likely it is that reincorporation will result in a 'race to the bottom'.

Moreover, the effectiveness of regulatory competition presumably depends on the context in which it operates. In contrast to the European Union, for example, the United States offers the advantage of homogeneous property and contract law across its member states and largely federalized bankruptcy and tax law.[76] Even so, only one among the fifty American states—Delaware—has made a sustained effort to attract incorporation by out-of-state firms.[77] It has been quite successful in this effort, now serving as the state of incorporation for roughly half of all U.S. publicly traded corporations, even though few of those corporations do any significant amount of business in Delaware. As part of its effort to remain attractive as a place of incorporation, Delaware's legislature regularly updates its corporation statute, generally deferring to a drafting committee dominated by practising lawyers. The Delaware judiciary, in turn, has a particular court (the 'chancery court') that is largely specialized to deal with corporate law cases, and is a constant source of judge-made law that interprets and supplements the statutory law. This focused attention to law-making clearly has important virtues, although not all agree that the result is an optimal body of corporate law.[78]

Of course, there is dispute as to what constitutes an 'optimal' body of corporate law, even in theory. That is our next topic.

[75] Bebchuk, *supra* note 74, at 1459–61, 1470–5; Simon Deakin, *Regulatory Competition Versus Harmonization in European Company Law*, in Regulatory Competition and Economic Integration, 190, 209–13 (Daniel C. Esty and Damien Geradin (eds.), 2001).

[76] On the implications of non-federalized tax and bankruptcy laws for regulatory competition in European corporate law, see Mitchall Kane and Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 Michigan Law Review 1229 (2008) (tax) and Horst Eidenmüller, *Free Choice in International Company Insolvency Law in Europe*, 6 European Business Organization Law Review 423 (2005); Armour, *supra* note 73, at 401–11; Luca Enriques and Martin Gelter, *Regulatory Competition in European Company Law and Creditor Protection*, 7 European Business Organization Law Review 417 (2006) (bankruptcy).

[77] In recent years, Nevada has made a modest and largely unsuccessful effort to compete with Delaware. Going back to the beginning of the 20th century, New Jersey was also a competitor.

[78] See, e.g., Jonathan R. Macey and Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 Texas Law Review 469 (1987); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 Columbia Law Review 1908 (1998).