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A New Approach to Corporate Choice of Law

*Jens Dammann**

ABSTRACT

The state of incorporation doctrine, which now applies both in the United States and in the European Community, allows corporations to choose the state law governing their internal affairs by incorporating in the appropriate state. Most scholars believe that this freedom to choose benefits both shareholders and society as a whole. Against this background, an obvious question is whether the state of incorporation doctrine is really the most efficient way of granting corporations the right to choose. In this Article, the Author argues that while there are sound reasons for retaining the state of incorporation doctrine as one mechanism for allowing corporations to choose the applicable corporate law, it should not be the only such mechanism because the state of incorporation doctrine does not allow corporations to choose the applicable corporate law in isolation, but forces them to accept certain "side effects," such as exposure to litigation in the state of incorporation. These side effects appear to be largely responsible for the general unwillingness of European firms to incorporate in the United States. Therefore, federal law in both Europe and the United States should ensure that corporations can choose the applicable corporate law in their articles of incorporation.

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I. INTRODUCTION

U.S. corporations can freely choose the state law governing their internal affairs,[1] a concept that can be referred to as free choice.[2] As a technical matter, free choice is granted by means of a choice-of-law rule. Under the so-called state of incorporation doctrine, it is the law of the state of incorporation, rather than the law of the state in which the corporation's headquarters is located, that governs the corporation's internal affairs.[3]

The question of whether free choice benefits shareholders has long occupied a central place in the corporate law literature. Some scholars argue that free choice harms shareholders because states, driven by the desire to collect franchise taxes, try to attract corporate charters by promulgating rules that favor managers at the expense of shareholders.[4] In contrast, a majority of scholars now seem to hold the opposite view. According to this group, state competition in corporate law benefits shareholders, at least on balance, because

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1. *See, e.g.*, Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT'L L. 477, 477 (2004) ("U.S. corporations are free to choose the state law governing their internal affairs."); Alan E. Garfield, Comment, *Evaluating State Anti-Takeover Legislation: A Broadminded New Approach to Corporation Law or "A Race to the Bottom"?*, 1990 COLUM. BUS. L. REV. 119, 122 (noting that "corporations are free to incorporate in whichever state they wish").

2. *See* Dammann, *supra* note 1, at 477.

3. See, e.g., Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 LAW & CONTEMP. PROBS. 161, 162-63 (1985).

4. *See, e.g.*, Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999) [hereinafter Bebchuk & Ferrell, *Federalism*] (claiming that state competition probably fails to maximize shareholder wealth); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663-92 (1974) (perceiving a "race for the bottom"); *cf.* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1872 (2002) (concluding that states that enact "typical" anti-takeover statutes fare better in the race for corporate charters than states enacting no anti-takeover statutes).

capital markets discipline managers sufficiently to ensure that corporations prefer states with efficient corporate law.[5] This Article does not seek to resolve this debate. Rather, the assumption here is that free choice is at least on the whole beneficial.[6]

In obvious contrast to the attention lavished on the race-to-the-top/race-to-the-bottom debate, comparatively little thought has been devoted to the issue of how free choice can be organized most efficiently.[7] In particular, existing scholarship completely ignores the question of whether it is truly efficient for federal law to use the state of incorporation doctrine as the exclusive mechanism for guaranteeing free choice in corporate law.

This Article suggests that the answer to that question should be no. To be sure, there are sound reasons for retaining the state of incorporation doctrine as *one* mechanism for granting free choice. But it should not be the only such mechanism. Rather, a federal statute should complement the state of incorporation doctrine by allowing corporations to choose the applicable state law in their articles of incorporation. Corporations could thus determine freely which corporate law regime should govern their internal affairs. The law of the state of incorporation should only govern by default, if the articles of incorporation do not contain any choice-of-law clause.

While the analysis in this Article is not without relevance for charter competition in the United States, its purpose goes beyond the context of the U.S. legal system. In fact, the primary goal is to gain an understanding of how any federal or international legal system

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5. This view was forcefully laid out by Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-92 (1977); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 222 (1991) (asserting that state competition "creates a powerful tendency for states to enact laws that operate to the benefit of investors"); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 16 (1993) [hereinafter ROMANO, GENIUS] (arguing that state competition "benefits rather than harms shareholders"); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 553-58 (2001) (finding that Tobin's Q of Delaware firms exceeds that of non-Delaware firms).

6. As regards the European Community, I have analyzed the reasons justifying this statement in detail elsewhere. *See* Dammann, *supra* note 1, at 507-43.

7. *But see* Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks*, 43 U. KAN. L. REV. 541, 549 (1995) [hereinafter Ayres, *Supply-Side Inefficiencies*] (pondering the possibility of a federal rule that prevents states from imitating the law of sister states for a limited number of years in order to increase the incentive for innovation); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 130, 143-45 (2001) [hereinafter Bebchuk & Ferrell, *New Approach*] (arguing that the federal legislature should provide an optional takeover regime that shareholders can opt into without the consent of management); Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 611-12 (2002) (suggesting that federal law should give shareholders the right to bring about a reincorporation decision even without the consent of the board).

can organize free choice most efficiently. The importance of that question is easily explained. Free choice in corporate law is no longer a concept confined to the United States alone.[8] Rather, as is explained in more detail elsewhere,[9] the state of incorporation doctrine—and with it the concept of free choice—recently entered the European stage. In the past, the European Community[10] (hereinafter, "Community") allowed its Member States to adopt a choice-of-law system that prevented free choice. Most Member States of the Community adhered to the so-called real seat doctrine, which dictates that the internal affairs of a corporation are governed not by the law of the state of incorporation but by the law of the state in which the corporation's headquarters is located.[11] As a result, corporations could not choose the law of another Member State unless they were willing to move their headquarters.[12] Because the costs of such a move usually outweighed the advantages connected with a more efficient corporate law,[13] the real seat doctrine effectively prevented free choice.

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8. It should not go unmentioned that a number of scholars have explored the relevance of the free choice concept for Canada. *See, e.g,.* ROMANO, GENIUS, *supra* note 5, at 118-128 (analyzing various reasons why there is little charter competition in Canada despite the country's adherence to the state of incorporation doctrine); Douglas J. Cumming & Jeffrey G. MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141, 147 (2000) (questioning the incentives of Canadian regulators to compete for corporate charters); Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 182-184 (1991) (claiming that charter competition is far less effective in Canada than it is in the United States).

9. *See* Dammann, *supra* note 1, at 480 (detailing two recent European Court of Justice cases putting an end to the real seat doctrine).

10. In the context of jurisdictional competition, scholars tend to refer to the European Union rather than to the European Community. *See, e.g.*, Subramanian, *supra* note 4, at 1869-72; Joel P. Trachtmann, *Regulatory Competition and Regulatory Jurisdiction*, 3 J. INT'L ECON. L. 331, 332 (2000). It should be noted, however, that the law governing the issues of relevance to the concept of free choice, such as the provisions on the Freedom of Establishment, is contained in the Treaty Establishing the European Community. *See* TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 3, as most recently amended by the TREATY OF NICE, Feb. 26, 2001, 2001 O.J. (C 80) 1-87 [hereinafter T.E.C.]. Hence, this Article will refer to the European Community and not to the European Union.

11. *See, e.g.*, ROMANO, GENIUS, *supra* note 5, at 132. In particular, Belgium, Germany, France, Luxembourg, Portugal, Spain, and Greece have traditionally applied the real seat doctrine. *See* Bernhard Großfeld, *Internationales Gesellschaftsrecht [Corporate Conflict of Laws]*, *in* J. VON STAUDINGERS KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH MIT EINFÜHRUNGSGESETZ UND NEBENGESETZEN 42-43 (Christian von Bar et al., eds., 1998) (on file with author) [hereinafter Großfeld, *Internationales Gesellschaftsrecht*].

12. *See, e.g.,* ROMANO, GENIUS, *supra* note 5, at 132.

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

Recently, however, this situation has changed. Three decisions by the European Court of Justice—*Centros*,[14] *Überseering*,[15] and *Inspire Art*[16]—have made it clear that the real seat rule, as traditionally applied by most Member States, is incompatible with the Freedom of Establishment guaranteed by the Treaty Establishing the European Community (TEC).[17] To be sure, the legal landscape in the Community is still a far cry from its U.S. counterpart. In particular, European corporations, while free to choose where to incorporate in the first place, may find it difficult to reincorporate later without suffering adverse tax consequences.[18] Nevertheless, the concept of free choice is no longer confined to the United States. Rather, it has also become the basic tenet underlying Community law.

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

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

16. Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155, 24 Zeitschrift für Wirtschaftsrecht [ZIP] 1885 (2003).

17. *See id.* ¶¶ 95-97

> [I]t is immaterial, having regard to the application of the rules on freedom of establishment, that the company was formed in one Member State only for the purpose of establishing itself in a second Member State, where its main, or indeed entire, business is to be conducted. . . . [The] location of their registered office . . . serves as the connecting factor with the legal system of a particular Member State in the same way as does nationality in the case of a natural person.

Id.; Centros Ltd., 1999 E.C.R. ¶ 39, 2 C.M.L.R. at 587-88.

> [I]t is contrary to arts 52 and 58 of the [EC] Treaty for a Member State to refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office but in which it conducts no business where the branch is intended to enable the company in question to carry on its entire business in the State in which that branch is to be created, while avoiding the need to form a company there, thus evading the application of the rules governing the formation of companies which, in that state, are more restrictive as regards the paying-up of a minimum share capital.

Id.; *Überseering BV*, 2002 E.C.R. ¶ 94.

> [W]here a company formed in accordance with the law of a Member State (A) in which it has its registered office is deemed, under the law of another Member State (B), to have moved its actual centre of administration to Member State B, Articles 43 EC and 48 EC preclude Member State B from denying the company legal capacity and, consequently, the capacity to bring legal proceedings before its national courts for the purpose of enforcing rights under a contract with a company established in Member State B.

Id.

18. Dammann, *supra* note 1, at 490-91.

It is also important to note that *Centros*, *Überseering*, and *Inspire Art* may well have set the stage for transatlantic charter competition. At first glance, that suggestion may seem somewhat counterintuitive. After all, the Freedom of Establishment underlying these judgments does not extend to U.S. corporations.[19] Nevertheless, *Centros*, *Überseering*, and *Inspire Art* are of essential importance to the existence or non-existence of a transatlantic market for corporate charters. The reason can be summed up as follows: As long as the Member States of the Community managed to prevent an intra-European market for corporate charters via the real seat rule, they could hardly be expected to eliminate the various obstacles that prevent European businesses from incorporating in the United States. Nor could the United States be expected to address the various obstacles to transatlantic charter competition existing on the U.S. side,[20] given that the prevalence of the real seat rule in Europe seemed to prevent transatlantic charter competition.[21]

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19. *Cf.* T.E.C., *supra* note 10, art. 48(1).

> Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States..

20. As is shown below, U.S. rules on corporate taxation, securities regulation, and adjudicative jurisdiction provide powerful incentives for European firms not to incorporate in the United States. *See infra* text accompanying notes 27-110.

21. To be sure, the United States has concluded bilateral treatments with many European countries, ensuring that the latter have to recognize the juridical status of U.S. corporations regardless of where the latter's real seat is located. *Cf., e.g.*, Treaty of Friendship, Commerce and Navigation, Oct. 29, 1954, U.S.-F.R.G., art. XXV(5)(2), 7 U.S.T. 1839, 1954 U.S.T. LEXIS 6, *33 ("Companies constituted under the applicable laws and regulations within the territories of either Party shall be deemed companies thereof and shall have their juridical status recognized within the territories of the other Party."). Treaties that the United States has concluded with other European countries contain identical provisions. *See, e.g.*, Treaty of Friendship, Establishment and Navigation, Feb. 23, 1962, U.S.-Lux., art. XV(3)(2), 14 U.S.T. 251, 1962 U.S.T. LEXIS 371, *22; Treaty of Friendship, Establishment and Navigation, Feb. 21, 1961, U.S.-Belg., art. 6(3)(1), 14 U.S.T. 1284, 1961 U.S.T. LEXIS 953, *9-10; Convention of Establishment, Nov. 25, 1959, U.S.-Fr., art. XIV(5), 11 U.S.T. 2398, 1959 U.S.T. LEXIS 384, *19; Treaty of Friendship, Commerce and Navigation, Mar. 27, 1956, U.S.-Neth., art. XXIII(3)(2), 8 U.S.T. 2043, 1956 U.S.T. LEXIS 217, *34; Treaty of Friendship, Commerce and Navigation, Oct. 1, 1951, U.S.-Den., art. XXII(3)(2), 12 U.S.T. 908, 1951 U.S.T. LEXIS 558, *29; Treaty of Friendship, Commerce and Navigation, Aug. 3, 1951, U.S.-Greece, art. XIV(3)(b), 5 U.S.T. 1829, 1951 U.S.T. LEXIS 560, *16; Treaty of Friendship, Commerce and Navigation, Jan. 21, 1950, U.S.-Ir., art. XXI(3)(2), 1 U.S.T. 785, 1950 U.S.T. LEXIS 261, *28. Other treaties contain similar provisions. *See, e.g.*, Treaty of Friendship, Commerce, and Consular Rights, June 19, 1928, U.S.-Aus., art. IX(1)(1), 1928 U.S.T. LEXIS 103, *1, *14.

> Limited liability and other corporations . . . which have been or may hereafter be organized in accordance with and under the laws . . . of either High Contracting Party and maintain a central office within the territories thereof,

With the abolition of the real seat rule, however, that situation has changed considerably. For those Member States of the Community whose businesses predominantly choose to incorporate elsewhere, it may be in the States' best interests to make it easier for local firms to incorporate in the United States. After all, such a course of action may benefit local businesses by giving them access to more efficient corporate law. At the same time, a real seat state may not care whether pseudo-foreign corporations avoid local corporate law by incorporating in another Member State or whether they do so by incorporating in Delaware. Needless to say, the United States, too, has every incentive to facilitate transatlantic charter competition. Given that the outcome of such competition would likely favor the more flexible U.S. law, states such as Delaware and Nevada would profit from additional revenue. In sum, *Centros*, *Überseering*, and *Inspire Art* are not only a boon to the intra-Community market for corporate charters, but they may also herald an era of transatlantic charter competition.

Against this background, it seems high time to focus not only on the general desirability of free choice in corporate law, but also on the question of how free choice should best be granted, be it in the U.S., the European, or the transatlantic arena.

Part II of this Article describes the main drawbacks of using the state of incorporation doctrine as the sole mechanism for guaranteeing free choice in corporate law. Part III suggests an alternative to the state of incorporation doctrine—namely, a statutory regime allowing corporations to choose the applicable law in their articles of incorporation. Part IV demonstrates the practical relevance of the scheme suggested in this Article by reference to the transatlantic charter market. Part V shows that there are no compelling reasons for retaining the state of incorporation doctrine as the sole mechanism for exercising free choice. Part VI suggests that doctrinal reasons rather than efficiency considerations explain why

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> shall have their juridical status recognized by the other High Contracting Party . . . .

The same provision is used in a number of other treaties. *See, e.g.*, Treaty of Friendship, Commerce, and Consular Rights, Feb. 13, 1934, U.S.-Fin., art. XVI(1)(1), 1934 U.S.T. LEXIS 81, *11; Treaty on Friendship, Commerce, and Consular Rights, June 15, 1931, U.S.-Pol., art. XI(1)(1), 1931 U.S.T. LEXIS 42, *1, *16-17; Treaty on Friendship, Commerce, and Consular Rights, Apr. 20, 1928, U.S.-Lat., art. XIII(1)(1), 1928 U.S.T. LEXIS 130, *13-14; Treaty on Friendship, Commerce, and Consular Rights, Dec. 23, 1925, U.S.-Est., art. XII(1)(1), 1925 U.S.T. LEXIS 134, *13; Treaty on Friendship, Commerce, and Consular Rights, June 24, 1925, U.S.-Hung., art. IX(1)(1), 1925 U.S.T. LEXIS 95, *11.

It is highly questionable, however, to what extent these treaty provisions actually enshrine the state of incorporation doctrine. That will be explained below with regard to the relevant treaty concluded between the United States and Germany. *See infra* text accompanying notes 138-59.

the state of incorporation doctrine, despite its shortcomings, has become the exclusive means for exercising free choice both in Europe and in the United States.

II. WHAT IS WRONG WITH THE STATE OF INCORPORATION DOCTRINE?

The state of incorporation doctrine, under which the internal affairs of a corporation are governed by the law of the state of incorporation, is a time-tested device for granting free choice in corporate law. As early as the eighteenth century,[22] British companies made use of this rule to conduct business in distant parts of the British Empire without having to forego the benefits of British law.[23] In the nineteenth century, French entrepreneurs used the state of incorporation doctrine to escape the rigors of their country's corporate law via incorporation in England or Switzerland.[24] Similarly, in the United States, it is the state of incorporation doctrine that enables corporations to choose the state law they find most attractive.[25] Even in Europe today, the reemergence of the free choice concept comes in the guise of that doctrine: the Court of Justice has made it clear that the Member States must recognize pseudo-foreign corporations as legal entities, thereby making it possible for corporations to choose a state's corporate law by incorporating in that state.[26] In sum, where legal systems have granted free choice in corporate law, they have generally done so by means of the state of incorporation doctrine.

Despite its impressive tradition, however, that doctrine proves to be a somewhat cumbersome mechanism for exercising free choice.

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22. The earliest known English case applying the state of incorporation doctrine seems to be a decision of the House of Lords from 1730. *See* Henriques v. The General Privileged Dutch Company Trading to the West Indies, 92 Eng. Rep. 494 (K.B. 1730). The decision is analyzed by Bernhard Großfeld, *Zur Geschichte der Anerkennungsproblematik bei Aktiengesellschaften* [*The History of the Theories Governing the Recognition of Foreign Stock Corporations*], 38 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALS PRIVATRECHT [RABELSZ] 344, 345-46 (1974) [hereinafter Großfeld, *Anerkennungsproblematik*].

23. *Cf.* Bernhard Großfeld, *Die Entwicklung der Anerkennungstheorien im internationalen Gesellschaftsrecht* [*The Development of the Theories on the Recognition of Foreign Legal Persons in the Corporate Conflict of Laws*], *in* FESTSCHRIFT FÜR HARRY WESTERMANN 199, 203 (Wolfgang Hefermehl et al. eds, 1974) (on file with author) [hereinafter Großfeld, *Anerkennungstheorien*].

24. *See id.* at 208-09 (noting that it became fashionable for French corporations in the second half of the nineteenth century to incorporate in the United Kingdom or in Switzerland and that this trend was the decisive reason for the triumph of the real seat doctrine in French law).

25. *Cf.* ROMANO, GENIUS, *supra* note 5, at 32, 132-33 (pointing out the essential role of the state of incorporation doctrine in creating a market for corporate charters).

26. *See* Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-10155, ¶¶ 94-95 (2003).

The underlying problem can be summed up as follows: The state of incorporation doctrine does not allow corporations to choose the applicable state law in isolation. Rather, it forces corporations to accept certain "side effects," a prospect that may deter corporations from choosing the corporate law they find most efficient.

A. *Exposure to Litigation in the State of Incorporation*

Perhaps the most well-known side effect of the state of incorporation doctrine is that incorporation in a state other than the real seat state exposes the corporation to litigation in that state.[27]

1. The Legal Rules Governing Exposure to Third-Party Suits

Under both U.S. and Community law, a corporation is exposed to the risk of litigation in its state of incorporation. First and foremost, that risk exists vis-à-vis the corporation's external affairs; U.S. states can—and routinely do—exercise jurisdiction over all third-party suits brought against domestic corporations.[28] To be sure, the parties can often avoid that result by means of forum selection clauses, which most states now recognize as valid if they are reasonable.[29] For practical reasons, however, it is not always possible to reach an agreement regarding the forum, especially in tort cases.

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27. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 2.11, at 55 (3d ed. 1986); Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 374-75 (1992) ("If the foreign state is geographically distant from the corporation's base of operations, the possibility of more expensive litigation might significantly raise the expected cost of foreign incorporation. This potential expense might not deter a closely held Philadelphia company from incorporating in Delaware, but might substantially chill the similar interest of a small Chicago business.").

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

29. Volkswagenwerk, A.G. v. Klippan, GmbH, 611 P.2d 498, 503 (Alaska 1980), *cert. denied*, 449 U.S. 974 (1980); Societe Jean Nicolas et Fils v. Mousseux, 597 P.2d 541, 542 (Ariz. 1979); SD Leasing, Inc. v. Al Spain & Assocs., 640 S.W.2d 451, 452 (Ark. 1982); Smith, Valentino & Smith, Inc. v. Superior Court of L.A. County, 551 P.2d 1206, 1208 (Cal. 1976); ABC Mobile Sys., Inc. v. Harvey, 701 P.2d 137, 139 (Colo. Ct. App. 1985); Funding Sys. Leasing Corp. v. Diaz, 378 A.2d 108, 109 (Conn. Super. Ct. 1977); Elia Corp. v. Paul N. Howard Co., 391 A.2d 214, 216 (Del. Super. Ct. 1978); Manrique v. Fabbri, 493 So. 2d 437, 440 (Fla. 1986); Calanca v. D & S Mfg. Co., 510 N.E.2d 21, 23 (Ill. App. Ct. 1987); Prudential Res. Corp. v. Plunkett, 583 S.W.2d 97, 99 (Ky. Ct. App. 1979); Hauenstein & Bermeister, Inc. v. Met-Fab Indus., Inc., 320 N.W.2d 886, 890 (Minn. 1982); High Life Sales Co. v. Brown-Forman Corp., 823 S.W.2d 493, 497 (Mo. 1992); Air Econ. Corp. v. Aero-Flow Dynamics, Inc., 300 A.2d 856, 856 (N.J. 1973); Credit Francais Int'l, S.A. v. Sociedad Financiera de Comercio, C.A., 490 N.Y.S.2d 670, 674 (N.Y. App. Div. 1985); United Standard Mgmt. Corp. v. Mahoning Valley Solar Res., Inc., 476 N.E.2d 724, 726 (Ohio Ct. App. 1984); Reeves v. Chem. Indus. Co., 495 P.2d 729, 732 (Or. 1972); St. John's Episcopal Mission Ctr. v. S.C. Dep't of Soc. Serv., 280 S.E.2d 207, 207 (S.C. 1981); Green v. Clinic Masters, Inc., 272 N.W.2d 813, 815 (S.D. 1978); Int'l Collection Serv., Inc. v. Gibbs, 510 A.2d 1325, 1327 (Vt. 1986).

Likewise, as a matter of Community law, corporations can be sued in the state in which where they are domiciled, [30] unless a forum selection agreement provides otherwise.[31] Indeed, exposure to such litigation is even greater in the Community than it is in the United States. While most U.S. states recognize the doctrine of forum non conveniens,[32] which may in some cases allow corporations to avoid having to litigate in the state of incorporation if that state is clearly inconvenient as a forum,[33] no such doctrine is recognized under Community law.[34]

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30. *See* Council Regulation 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, art. 2(1) 2001 O.J. (L 12) 1-23 [hereinafter CR-JREJ] ("Subject to this Regulation, persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State."); *see also id.* at art. 60(1) ("For the purposes of this Regulation, a company or other legal person or association of natural or legal persons is domiciled at the place where it has its: (a) statutory seat, or (b) central administration, or (c) principal place of business.").

31. *Cf. id.* art. 23(1) ("If the parties . . . have agreed that . . . the courts of a Member State are to have jurisdiction . . . those courts shall have jurisdiction. Such jurisdiction shall be exclusive unless the parties have agreed otherwise.").

32. *See, e.g.*, Stangvik v. Shiley, Inc., 819 P.2d 14, 17-18 (Cal. 1991); Union Carbide Corp. v. Aetna, Casualty & Surety, Co., 562 A.2d 15, 17 (Conn. 1989); Parvin v. Kaufmann, 236 A.2d 425, 427 (Del. 1967); Bland v. Norfolk & W. Ry., 506 N.E.2d 1291, 1293-1294 (Ill. 1987); MacLeod v. MacLeod, 383 A.2d 39, 41-43 (Me. 1978); Varkonyi v. S.A. Empresa de Viacao A.R.G., 239 N.E.2d 542, 544 (N.Y. 1968); Chambers v. Merrell-Dow Pharm., 519 N.E.2d 370, 372-73 (Ohio 1988); Zurick v. Inman, 426 S.W.2d 767, 768-72 (Tenn. 1968).

33. It should be noted, though, that the mere fact that a corporation's only link with the state of incorporation is the corporation's being incorporated there will not necessarily suffice to invoke the *forum non conveniens* doctrine. Under Delaware law, for example, the *forum non conveniens* doctrine can only be applied in cases of "overwhelming hardship." *See* Taylor v. LSI Logic Corp., 689 A.2d 1196, 1197-99 (Del. 1997); Chrysler First Bus. Credit Corp. v. 1500 Locust Ltd. Partnership, 669 A.2d 104, 108 (Del. 1995); Kolber v. Holyoke Shares, 213 A.2d 444, 446-47 (Del. 1965). The fact that a case's only connection to Delaware is the defendant's status as a Delaware entity does not change that test. *See, e.g.*, Mar-Land Indus. Contrs., Inc. v. Caribbean Petroleum Ref., L.P., Supreme Court of Delaware, 777 A.2d 774, 782 (Del. 2001).

34. *See, e.g.*, Konstantinos D. Kerameus, *Political Integration and Procedural Convergence in the European Union,* 45 AM. J. COMP. L. 919, 923 n.14 (1997) ("It must be noted that the concept of *forum non conveniens* remains unknown in the system of the Brussels Convention."); Martine Stuckelberg, Lis Pendens *and* Forum Non Conveniens *at the Hague Conference*, 26 BROOK. J. INT'L L. 949, 962-64 (2001) ("[T]he Convention does not contain any *forum non conveniens* clause."). Both sources refer to the Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters, Sept. 27, 1968 (amended 1978, 1982, 1989), 1990 O.J. (C 189) 1. That convention preceded the CR-JREJ and was largely identical with the latter.

As regards the transatlantic charter market, the following peculiarity should be noted: a U.K. court once suggested that the courts of a Member State may invoke the *forum non conveniens* doctrine under the Member State's own procedural law, where the most convenient forum is located outside of the European Community. In such a case, the U.K. court argued, the Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters does not apply. *See In Re* Harrods (Buenos Aires) Ltd., [1991] 3 W.L.R. 397 (Eng. C.A. 1990). Obviously, that decision is relevant to the transatlantic charter market in that it might allow U.S. firms

2. The Need to Litigate Internal Affairs in the State of Incorporation

The need to litigate in the state of incorporation can also concern a corporation's internal affairs. This problem does not usually occur in the United States. Most states recognize outbound forum selection clauses[35] and, as a result, a corporation's articles of incorporation can simply specify the real seat state as a forum. In the European Community, however, the situation is more problematic. While Community law generally allows forum selection clauses, certain internal affairs must be litigated in the state of incorporation,[36] and forum selection clauses providing otherwise are void.[37]

3. The Practical Relevance of Having to Litigate in the State of Incorporation

In the United States, the prospect of exposure to litigation in the state of incorporation may deter mainly small businesses from incorporating outside of their real seat state.[38] By contrast, in the European and the transatlantic charter markets, the risk of having to litigate in the state of incorporation may lead even larger firms to abstain from incorporating in the state whose law they find most efficient. At least two factors justify this assessment. Most

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incorporated in the Community to avoid litigation in Europe. Indeed, in the above-mentioned case, the court was faced with a conflict between shareholders of a corporation that had been formed in England, but operated exclusively in Argentina. *See id.* However, two caveats are necessary. First, the relevant case was settled before the European Court of Justice gave a preliminary ruling. It is not clear, therefore, whether the Court of Justice would adopt the same view as the English court cited above. Second, the inapplicability of the CR-JREJ does not necessarily imply that the national court can invoke the *forum non conveniens* doctrine. Where Community law does not apply, the Member States' courts will rely on national law. Yet civil law systems—which prevail in the European Community—typically do not have the *forum non conveniens* doctrine. *See, e.g.*, Stuckelberg, *supra*, at 958.

35. *See* sources cited *supra* note 29.

36. *Cf.* CR-JREJ, *supra* note 30, art. 22.

> The following courts shall have exclusive jurisdiction, regardless of domicile . . in proceedings which have as their object the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or of the validity of the decisions of their organs, the courts of the Member State in which the company, legal person or association has its seat. In order to determine that seat, the court shall apply its rules of private international law. . . .

Id.

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

38. In fact, it is only with regard to close corporations that the literature mentions exposure to litigation as an obstacle to corporate mobility. *See* sources cited *supra* note 29.

important, language barriers must be taken into account. In the transatlantic charter market, the inconvenience of geographical distance is also bound to be greater than in the United States.

B. *Securities Regulation*

The state of incorporation doctrine may also discourage corporate mobility by burdening pseudo-foreign corporations with disadvantages pertaining to the area of securities regulation. In particular, the need to comply with additional registration and disclosure requirements may serve as a deterrent to incorporation in a foreign jurisdiction.

1. The U.S. Charter Market

With regard to the U.S. charter market, the disadvantage is comparatively small. To be sure, as Ayres has pointed out, the Securities Act of 1933 (hereinafter, "Securities Act") provides an incentive for close corporations to incorporate locally.[39] Section 3(a)(11) of the Securities Act explicitly exempts those securities that are part of an issue offered and sold only to persons residing within a single state, if the issuer of such security is a corporation incorporated in and doing business in that state.[40] The moment a corporation incorporates outside its real seat state, it loses that privilege.[41] But the practical relevance of this obstacle to corporate mobility is probably limited. The courts have interpreted § 3(a)(11) of the Securities Act rather narrowly,[42] making it—in the words of a leading treatise—"a feasible alternative in only a relatively few situations."[43] Moreover, many of the firms that are small enough to make use of § 3(a)(11) will also be able to benefit from one of the other exceptions granted by the Securities Act.[44] Hence, few corporations will be deterred from incorporating outside of the real seat state for fear of losing the intrastate offerings privilege.[45]

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39. Ayres, *supra* note 27, at 375.
40. *See* 15 U.S.C. § 77c(a)(11) (2003).
41. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 343 (4th ed. 2002).
42. *Cf.* Midwest Mgmt. Corp. v. Stephens, 291 N.W.2d 896, 910 (Iowa 1980) (noting that "section 3(a)(11) . . . is construed quite narrowly").
43. HAZEN, *supra* note 41, at 340.
44. *See id.* at 341 n.5.
45. Another question is, of course, whether the U.S. rules on securities regulation inefficiently restrict free choice by making it impossible for issuers to choose between different regimes on securities regulation. But that question has been analyzed in much detail elsewhere and hence shall not be addressed in this Article. *See* Stephen J. Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 914-51 (1998) [hereinafter Choi & Guzman, *Portable Reciprocity*] (arguing that issuers should be able

2. The European Charter Market

Likewise, in the European market for corporate charters, the relevant provisions are unlikely to be a severe obstacle to corporate mobility because the Member States of the Community have traditionally shown comparatively little inclination to apply their registration and disclosure regimes to corporations that are not listed on local securities exchanges. German securities law may illustrate this point. Under the German Börsengesetz (Securities Exchange Act), securities issued by German corporations must be registered only if they are to be listed on a German stock exchange.[46] Similarly, the German rules governing periodic disclosure and the ad-hoc disclosure of new information apply only to those corporations whose shares are listed on a German stock exchange.[47] Hence, the relevant registration and disclosure requirements hardly lead foreign-based firms to refrain from incorporating in Germany.[48]

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to choose which country's securities law regime they wish to comply with); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2401-18 (1998) [hereinafter Romano, *Empowering Investors*] (arguing that state law should govern securities fraud and periodic disclosure so as to allow issuers to choose between various regimes).

46. *See* § 30 (1) Börsengesetz (BörsG), v. 21.6.2002 (BGBl. I S.2010).

> Wertpapiere, die im amtlichen Markt an der Börse gehandelt werden sollen, bedürften der Zulassung, soweit nicht in § 36 oder in anderen Gesetzen ein anderes bestimmt ist. [Securities that are to be traded as part of the official market at a stock exchange require registration unless it is provided otherwise in § 36 or in other statutes.].

47. *See* § 40 (1) Börsengesetz (BörsG), v. 21.6.2002 (BGBl. I S.2010) ("Der Emittent zugelassener Aktien ist verpflichtet, innerhalb des Geschäftsjahres regelmäßig mindestens einen Zwischenbericht zu veröffentlichen. . . . [The Issuer of registered shares is required to publish at least an interim report within the business year. . . .]"); *see also* § 15(1)(1) Gesetz über den Wertpapierhandel Wertpapierhandelsgesetz—WpHG), v. 26.7.1994 (BGBl. I S.1749).

> Der Emittent von Wertpapieren, die zum Handel an einer inländischen Börse zugelassen sind, muß unverzüglich eine neue Tatsache gemäß § 15 Abs. 2 Satz 1 veröffentlichen. . . . [The Issuer of Securities that have been admitted to trade at a domestic stock exchange, must disclose without delay new facts according to § 15(2)(1). . . .].

48. For the sake of clarity, it should be pointed out that the above-described German rules on registration and disclosure requirements cannot, at present, gain relevance to the market for corporate charters in any case: under German corporate law, corporations cannot incorporate in Germany unless their real seat is also located in Germany. *See, e.g.*, BGHZ 51, 27 (28) (holding that a corporation's internal affairs are governed by the law of the real seat state). Community law does not prohibit this practice. In its famous *Daily Mail* decision from 1988, the Court of Justice explicitly held that:

> [T]he legislation of the Member States varies widely in regard to . . . the factor providing a connection to the national territory required for the incorporation of a company. . . . [T]he Treaty regards the differences in national legislation

3. The Transatlantic Charter Market

In contrast, the state of incorporation doctrine, in combination with the laws governing registration and disclosure requirements, is bound to be a severe obstacle to the transatlantic charter market. The problem in this context does not lie so much on the European side. Once again, the German rules governing the registration of securities as well as periodic disclosure and ad-hoc disclosure may illustrate this point. As mentioned before, the scope of the application of the relevant rules is restricted to securities listed in Germany.[49] Registration and disclosure duties under U.S. securities law, however, are likely to be a fundamental obstacle to transatlantic charter competition.

a. The Securities Act of 1933

Of particular importance in this context is § 5 of the Securities Act. Under this provision, an issuer has to file a registration statement[50] and, under certain circumstances, distribute a prospectus to investors.[51] According to its wording, § 5 covers all offers and sales of securities that "make use of any means or instruments of transportation or communication in interstate commerce."[52] It is important to note, in this context, that interstate commerce in this sense is not just commerce between the states. Rather, Securities Act § 2(7) makes it clear that the term "interstate commerce" includes "trade or commerce in securities or any transportation or communication relating thereto" between "any foreign country and any State."[53] Hence, if a European firm's U.S. lawyers get involved in the transaction via telephone calls, the preconditions for interstate commerce may already be met.[54]

> concerning the required connecting factor . . . as [a problem] which [is] not resolved by the rules concerning the right of establishment. . . .

See Case C-81/87, Queen v. HM Treasury & Commissioners of Inland Revenue *ex parte* Daily Mail & General Trust plc, 1988 E.C.R. 5483, ¶¶ 20-23, [1988] 3 C.M.L.R. 713, 725-26 (1988).

49. *See supra* text accompanying notes 46-47,

50. *See* 15 U.S.C. § 77(e)(a) (2003).

51. *See* 15 U.S.C. § 77(e)(b)(2) (2003).

52. *See* 15 U.S.C. § 77(e)(a)(1) (2003).

53. *See* 15 U.S.C. § 77(b)(a)(7) (2003).

54. *Cf.* Matheson v. Armbrust, 284 F.2d 670, 673 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961) (holding that interstate commerce was involved where the defendant, a resident of Oregon and sole owner of a corporation, and plaintiff, also a resident of Oregon, negotiated in that state for sale of stock to plaintiff in which negotiations were broken off, and later defendant telephoned from Oregon to plaintiff in Washington to request that the latter return to Oregon and resume negotiations, which he did, and in purchase of stock was defrauded).

Admittedly, the scope of application of § 5 is limited by Regulation S, which is contained in Rules 901 through 904 of the Securities Act.[55] According to Rule 901, § 5 does not apply to "offers and sales that occur outside the United States."[56] From this wording, one might get the impression that European firms, whose only connection with the United States is their statutory domicile in Delaware, will easily be able to avoid the application of § 5 as long as they do not seek access to U.S. capital markets. But that impression would be wrong. While such firms can indeed manage to prevent the application of § 5, the necessary steps can be burdensome.

In order to be certain that Regulation S applies, one has to ensure that a transaction falls under one of the two safe harbor provisions that the Regulation sets out. One of these safe harbors is contained in Rule 903 and concerns issuers.[57] The other is governed by Rule 904 and applies to persons "other than the issuer, a distributor, any of their respective affiliates . . . or any person acting on behalf of any of the foregoing."[58] Rule 904, in other words, concerns the resale of securities by third parties. Any offer or sale that meets the requirements of either Rule is "deemed to occur outside the United States" [59] and is therefore exempt from § 5.[60]

But shares issued by U.S. corporations, even if headquartered abroad, do not easily fulfill the preconditions set forth by Rule 903 or Rule 904.[61] Consider, first, Rule 903. For that Rule to apply, securities must meet three requirements. Two of these requirements are met relatively easily: the offer or sale must be made in an offshore transaction,[62] and there must be no directed selling efforts in the United States.[63] The third requirement is, however, far more challenging: the transaction has to fall into one of the three categories set out in Rule 903(b).[64] Shares issued by U.S. corporations will

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55. *See* 17 C.F.R. §§ 230.901-904 (2003).
56. *See* 17 C.F.R. § 230.901 (2003).
57. *See* 17 C.F.R. § 230.903(a) (2003).
58. *See* 17 C.F.R. § 230.904(a) (2003).
59. *See* 17 C.F.R. §§ 230.903(a), 230.904(1) (2003).
60. *See* 17 C.F.R. § 230.902 (2003).
61. *Cf.* Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696, 709 (1998) [hereinafter Fox, *Political Economy*] (noting that "[u]nder Regulation S, a U.S. issuer that scrupulously offers its shares only to persons residing abroad and lists the shares only on a foreign stock exchange will ultimately still have difficulty avoiding compliance with U.S. disclosure requirements"); Frederick Tung, *From Monopolists to Markets? A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WIS. L. REV. 1363, 1376 n.55 (pointing out that "[p]ractical application of Regulation S and Exchange Act registration rules to U.S. issuers also makes it highly unlikely that even a U.S. firm that publicly offers shares only abroad could avoid U.S. disclosure rules").
62. *See* 17 C.F.R. § 230.903(a)(1) (2003).
63. *See* 17 C.F.R. § 230.903(a)(2) (2003).
64. *See* 17 C.F.R. § 230.903(a)(3) (2003).

generally not fit into categories one or two. Some narrowly drafted exemptions notwithstanding, these two categories apply mainly to securities offered by non-U.S. issuers as well as non-convertible debt securities offered by domestic issuers.[65] That leaves European firms incorporated in the United States with category three. But in order for its shares to fall into that category, a corporation has to shoulder a significant burden: as a general rule, a corporation issuing equity securities has to respect a one-year compliance period[66] that begins when the securities are first offered in reliance on Regulation S or the date of closing of the offering, whichever is later.[67] Offers or sales made prior to the expiration of that compliance period have to meet a number of conditions. Most important, the sale must not be made to a U.S. person.[68] Obviously, that condition is bound to be challenging, should a substantial number of European firms be incorporated in the United States, because Rule 902 makes it clear that U.S. corporations count as U.S. persons.[69] Furthermore, the purchaser must certify that he is not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person.[70] The purchaser of the securities must also agree to resell the relevant securities only in accordance with the provisions of Regulation S or pursuant to an available exemption from registration.[71] Last but not least, the securities must contain a legend to the effect that transfer is prohibited except in accordance with the provisions of Regulation S, pursuant to registration under the Act, or pursuant to an available exemption from registration.[72] In sum, while the preconditions set forth by Rule 903 are by no means impossible to fulfill, European firms incorporated in the United States will probably find compliance with the relevant provisions to be at least highly inconvenient.[73]

A similar picture emerges with regard to Rule 904, which also imposes significant restrictions. Like Rule 903, the offer or sale must

65. *See* 17 C.F.R. §§ 230.903(b)(1)-(2) (2003).
66. *See* 17 C.F.R. § 230.902(f) (2003).
67. *See* 17 C.F.R. § 230.902(f).
68. *See* 17 C.F.R. § 230.903(b)(3)(iii)(A) (2003).
69. *See* 17 C.F.R. § 230.902(k)(ii) (2003).
70. *See* 17 C.F.R. § 230.903(b)(3)(iii)(B)(1) (2003).
71. *See* 17 C.F.R. § 230.903(b)(3)(iii)(B)(2) (2003).
72. *See* 17 C.F.R. § 230.903(b)(3)(iii)(B)(3) (2003).
73. It is no surprise, therefore, that a shorter compliance period is sometimes suggested. *See, e.g.*, Stephen J. Choi, *The Unfounded Fear of Regulation S: Empirical Evidence on Offshore Securities Offerings*, 50 DUKE L.J. 663, 671 (2000) (suggesting that a more tailored response to the specific risks of offshore offerings should allow regulators to shorten the compliance period); Jon B. Jordan, *Regulation S and Offshore Capital: Will the New Amendments Rid the Safe Harbor of Pirates?*, 19 NW. J. INT'L L. & BUS. 58, 129 (1998) (arguing that if the amendments to Regulation S discussed therein prevent the abuse of Regulation S, then the SEC should consider shortening the compliance period from one year to six months).

be made in an offshore transaction,[74] and no directed selling efforts can be made in the United States.[75] Furthermore, neither the seller nor any person acting on its behalf must know that the offeree or buyer is a U.S. person.[76] Finally, if the seller knows that the buyer is a dealer or is receiving remuneration, the seller must send a confirmation or other notice that the securities may be offered or sold during the distribution compliance period only in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption.[77]

To the extent that European firms are unable to meet the requirements of Regulation S, they will also be unable to avoid completely the antifraud provisions of U.S. securities law because § 11 of the Securities Act imposes civil liability for false registration statements.[78] The application of that provision is unlikely to fail for jurisdictional reasons, given that the claim is based on a statement registered in the United States.[79]

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74. *See* 17 C.F.R. § 230.904(a)(1) (2003).
75. *See* 17 C.F.R. § 230.904(a)(2) (2003).
76. *See* 17 C.F.R. § 230.904(b)(1)(i) (2003).
77. *See* 17 C.F.R. § 230.904(b)(1)(ii) (2003).
78. *See* 15 U.S.C. § 77(k)(a) (2003).
79. By contrast, European firms may well be able to avoid the application of Rule 10b-5, under s. 10(b) of the Securities and Exchange Act (SEA), as long as they manage to confine their activities to Europe and do not have their shares listed in the United States. Rule 10b-5, under § 10(b) of the SEA, applies to all transactions "in connection with the purchase or sale of any security." *See* 17 C.F.R. § 240.10(b)(5) (2003). It is not entirely clear to what extent that provision covers offshore transactions. *Cf., e.g.*, Choi & Guzman, *Portable Reciprocity, supra* note 45, at 912 (noting that courts "have grappled with the issue of extraterritoriality on a case-by-case basis"). The wording of the Exchange Act is once again fairly expansive. Section 10(b) of the SEA only requires the use of "any means or instrumentality of interstate commerce." *See* 15 U.S.C. § 78(j) (2003). As mentioned above, interstate commerce includes "communication . . . between any foreign country and any State." *See* 15 U.S.C. § 78(c)(a)(17) (2003). But the question remains to what degree there are jurisdictional limits to the application of s. 10(b) of the SEA. The SEC has so far failed to clarify the reach of Rule 10b-5 outside the United States, leaving the issue to the courts. *See* Choi & Guzman, *Portable Reciprocity, supra* note 45, at 912. U.S. courts have developed two tests in this context—namely, the conduct test and the effects test. *See id.* Under both tests, European firms incorporated in the United States will likely be able to avoid the application of § 10(b) of the SEA.

Thus, under the conduct test, it is decisive where the conduct leading to the violation of § 10b-5 of the SEA has taken place. Courts hold different views, however, as to the question of what constitutes conduct. *See* Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Laws*, 17 NW. J. INT'L L. & BUS. 207, 217 (1996). According to one theory, the antifraud provisions "do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses." *See* Europe & Overseas Commodity Traders, S.A. v. Banque Paribas London, 147 F.3d 118, 128 (2d Cir. 1998) (citing Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 993 (2d Cir. 1975)); Psimenos v. E.F. Hutton & Co., 722 F.2d 1041, 1045 (2d Cir. 1983) (citing *Bersch*). Other courts have adopted a more aggressive position, considering it sufficient for jurisdictional purposes that "at least some activity designed to further a

b. The Securities Exchange Act of 1934

The duties imposed by the Securities Exchange Act of 1934 (hereinafter, "Exchange Act") are even harder to avoid for U.S. corporations headquartered in Europe. Of essential importance in this context is § 12(g)(1) of the Exchange Act, which imposes a registration requirement for equity securities not listed on a national stock exchange if the issuer is engaged in interstate commerce, has more than 500 shareholders of record, and more than $10 million in assets.[80] Section 12(g)(1) does not draw any distinction between foreign and private security holders.[81] Hence, even if a U.S. corporation's shareholders are exclusively in Europe, they may still have to comply with the registration requirement imposed by § 12(g)(1).[82]

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fraudulent scheme occurs within this country," *see* Sec. Exch. Comm'n v. Kasser, 548 F.2d 109, 114 (3d Cir. 1977), or assuming jurisdiction "whenever there has been significant conduct with respect to the alleged violations in the United States." *See* Travis v. Anthes Imperial Ltd., 473 F.2d 515, 524 (8th Cir. 1973). Under both views, European corporations should be able to escape liability as long as they do not register false information with the SEC and confine all their activities to Europe.

Under the effects test, the antifraud provisions can apply to events taking place outside the United States, "at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors." *See* Schoenbaum v. Firstbrook, 405 F.2d 200, 208 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969). But under that test, European firms should find it even easier to avoid the application of Rule 10b-5. They simply have to ensure that their shares are not registered or listed in the United States.

It should be noted that the above-described reasoning also applies to § 12(a)(2) of the SEA, which governs civil liability with respect to prospectuses and communications. *Cf.* CL-Alexanders Laing & Cruickshank v. Goldfeld, 709 F. Supp. 472, 476-80 (S.D.N.Y. 1989) (applying the conduct test and the effects test).

80. More precisely, § 12(g)(1) SEA applies to issuers with total assets of more than $1,000,000. *See* 15 U.S.C. § 78l(g)(1) (2003). However, Rule 12(g)(3) contains an exemption for issuers with assets totaling less than $10,000,00. *See* 17 C.F.R. 240.12g-1 (2004).

81. *See* Fox, *Political Economy, supra* note 61, at 715 n.47; Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498, 2615 (1997) [hereinafter Fox, *Who Should Regulate Whom?*]. In fact, the only exemption to the duty to register under § 12(g)(1) of the SEA that specifically deals with the foreign character of the securities involved is Rule 12(g)(3)-(2). *See* Fox, *Political Economy, supra* note 61, at 715 n.47. That provision, however, does not apply to corporations incorporated in the United States. *See* 17 C.F.R. § 240.3b-4(b) (2003) ("The term foreign issuer means . . . a corporation or other organization incorporated or organized under the laws of any foreign country.").

82. *See* Tung, *supra* note 61, at 1376 n.55 (arguing that "[f]or the U.S. issuer, whether its shareholders are foreign or domestic does not affect this registration requirement"); *see also* Fox, *Political Economy, supra* note 61, at 715 n.47 (noting that "[b]ecause foreign issuers are covered unless exempted pursuant to a rule or regulation . . . an issuer, being from the United States, surely would, absent such an exemption, be covered as well, even if most of its shareholders are abroad"); Fox, *Who Should Regulate Whom?, supra* note 81, at 2616-17 (pointing out that "[t]he simple fact that the issuer has gone public, regardless of where most of its shareholders reside, is

Admittedly, a caveat is necessary. While there is no specific exemption to § 12(g)(1), the provision that covers the cases at hand, one should bear in mind that § 12(h) allows the SEC to "exempt . . . any issuer or class of issuers from the provisions of [§ 12(g)] . . . if . . . such action is not inconsistent with the public interest or the protection of investors."[83] As Merritt B. Fox has pointed out,[84] at least four U.S. issuers with fewer than 300 U.S. shareholders have requested such an exemption. And while the requested exemptions apparently were not issued, the SEC made it clear that it would not object to the issuers' decision not to register under § 12(g)(1).[85] Nevertheless, the practical importance of this loophole should not be overestimated. The lack of a formal exemption means that corporations taking the above-described road will be on shaky ground, and most corporations will desire much more certainty before they are willing to incorporate in the United States.

It should be noted, finally, that the duty to register under § 12(g)(1) of the Exchange Act is of particular importance because it leads to the application of other provisions as well. For example, it gives rise to the duty to file periodic and other reports with the SEC under § 13 of the Exchange Act.[86] Also, subject to the interstate commerce requirement, the proxy solicitation rules under § 14 apply.[87] Finally, in the case of false or misleading statements in any report or other filed document, the corporation may be subject to liability under § 18 of the Exchange Act.[88]

That the above-described extra-territoriality of the U.S. securities laws presents a serious obstacle to the transatlantic charter market should be fairly obvious. As Ayres has pointed out, registration and disclosure costs under the federal securities laws in the United States can be substantial.[89] As a result, few firms headquartered in Europe will be willing to incorporate in the United States.

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enough to trigger imposition of the U.S. regime if the issuer remains incorporated in the United States").

83. *See* 15 U.S.C.S. § 78h (Law. Co-op. 2003).

84. Fox, *Political Economy*, *supra* note 61, at 715 n.47.

85. *See* Equitable American Property Company, Inc., SEC No-Action Letter, 1989 WL 246608 (Dec. 19, 1989); Paribas Properties, Inc., SEC No-Action Letter, 1988 WL 233751 (Feb. 29, 1988); States Properties, Inc., SEC No-Action Letter, 1987 WL 108725 (Nov. 30, 1987); Petrogen Petroleum, Inc., SEC No-Action Letter, 1987 WL 108480 (Oct. 12, 1987).

86. *See* 15 U.S.C.S. § 78m (Law. Co-op. 2003).

87. *See* 15 U.S.C.S. § 78n (Law. Co-op. 2003).

88. *See* 15 U.S.C.S. § 78r (Law. Co-op. 2003).

89. *See* Ayres, *supra* note 27, at 375.

C. *Double Taxation*

The state of incorporation doctrine can also be an obstacle to corporate mobility in that the decision to incorporate in a jurisdiction other than the real seat state can subject corporations to double-taxation.

1. The U.S. Charter Market

It should be noted that this problem does not concern the U.S. charter market. U.S. states competing for corporate charters have every incentive to refrain from imposing income taxes on corporations whose only connection with the state is their statutory domicile. Consequently, Delaware has a corporate income tax of 8.7 percent,[90] but profits made in other states are not taxed.[91] Taxes imposed by the real seat state no longer constitute an obstacle to corporate mobility either. Faced with an Alabama statute that imposed higher franchise taxes on foreign corporations than on domestic ones, the U.S. Supreme Court has recently made it clear that the Commerce Clause prohibits such discrimination.[92]

2. The European Charter Market

In the European market for corporate charters, double taxation is not an obstacle to corporate mobility either. The bilateral agreements between the Member States of the European Community to avoid double taxation typically follow the Model Double Taxation Convention on Income and Capital (MDTC) of the Organisation for Economic Co-operation and Development (OECD).[93] As a result, corporations have little to fear from incorporating in another Member State. According to MDTC Articles 3(1)(d) and 7(1), the profits of an enterprise carried on by the resident of a Contracting State shall, in principle,[94] be taxed only in that Contracting State. The decisive question, therefore, is where a pseudo-foreign corporation resides. That question is answered by MDTC Article 4(1). Under that provision, both the place of management and the place of

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90. *See* DEL. CODE ANN. tit. 30, § 1902(a) (2003).

91. *See* DEL. CODE ANN. tit. 30, § 1902(b) (2003).

92. South Central Bell Tel. Co. v. Alabama, 526 U.S. 160, 170-71 (1999).

93. *See, e.g.*, OTTO H. JACOBS, INTERNATIONALE UNTERNEHMENSBESTEUERUNG 68 (4th ed. 1999) (on file with author). For the text of the MDTC, see OECD, MODEL TAX CONVENTION ON INCOME AND CAPITAL: CONDENSED VERSION (1996). The text of the convention is also available at http://www.oecd.org/dataoecd/52/34/1914467.pdf.

94. An exemption applies if the enterprise carries on business in the other contracting state through a permanent establishment situated therein. *See* art. 7(1) MDTC, *reprinted in* OECD, *supra* note 93.

incorporation suffice to establish residency. Obviously, with regard to corporations of the type at issue, this provision would often lead the corporation to reside in both the real seat state and the state of incorporation. To eliminate this problem, Article 4(3) declares the place of effective management to be decisive. It follows that the pseudo-foreign corporation will have to pay income taxes only in the real seat state.[95]

3. The Transatlantic Charter Market

By contrast, double taxation is bound to be an important obstacle to the transatlantic charter market. In particular, European firms may well be deterred from incorporating in the United States for fear of being subject to additional taxes. The governing rules are highly complex, and because of the existence of bilateral agreements, they may differ depending on which European country is involved. Hence, it is beyond the scope of this Article to undertake a comprehensive analysis of the problem at hand. But the general problem can easily be illustrated by focusing on the example of a firm that is headquartered and operates exclusively in Germany but is incorporated in the United States.

In principle, such a firm would be subject to corporate level income taxes both in the United States and in Germany with regard to its income derived in Germany. Under § 1(1)(4) of the German Corporate Income Tax Act (Körperschaftssteuergesetz), any legal person having its corporate headquarters (Geschäftsleitung) in Germany is subject to German corporate taxation with regard to its worldwide income.[96] At the same time § 7701(4) of the Internal Revenue Code (IRC) makes it clear that a corporation formed in the United States is considered a domestic corporation. As such, it is subject to U.S. federal income taxation with regard to its worldwide income.[97]

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95. *See* art. 7(1) MDTC, *reprinted in* OECD, *supra* note 93. Of course, the question remains whether the Member States might impose higher taxes on dividends distributed by pseudo-foreign corporations than on dividends distributed by domestic corporations. But such discrimination would presumably violate the Freedom of Establishment, given that there is no reason for treating pseudo-foreign corporations differently from domestic ones in the area of taxation. In any case, the Member States do not seem to draw any distinction between domestic and pseudo-foreign corporations when it comes to taxes imposed on dividends. *See, e.g.*, § 2(1) German Einkommensteuergesetz 2002 (EStG 2002), v. 19.10.2002 (BGBl. I S.4210) (on file with author) [hereinafter EStG 2002].

96. *See* § 1(1) Körperschaftsteuergesetz 2002 (KStG 2002), v. 15.10.2002 (BGBl. I S.4144) (on file with author) [hereinafter KStG 2002].

97. *See* 26 U.S.C.S. § 11(a) (Law. Co-op. 2003) ("A tax is hereby imposed for each taxable year on the taxable income of every corporation."); *see also* REUVEN S. AVI-YONAH, U.S. INTERNATIONAL TAXATION 13 (2002) (noting that U.S. tax law subjects U.S. citizens to taxation with regard to their world-wide income).

The U.S.-German Tax Treaty does not eliminate this problem.[98] In principle, the relevant provisions of the Treaty follow those of the above-described MDTC.[99] The Tax Treaty, however, is far less generous with regard to cases in which a corporation's place of incorporation and place of management differ. Unlike MDTC Article 4(3), Article 4(3) of the Tax Treaty does not declare the effective place of management to be decisive; rather, this provision makes it clear that if a corporation resides in both Contracting States, then the competent authorities of the Contracting States shall seek to determine through consultation where the relevant corporation is deemed to reside.[100] If they are unable to agree, then both Contracting States can subject the corporation to taxation with regard to its worldwide income. It is crucial to note, in this context, that the Tax Treaty does not impose any duty on the authorities involved to make the relevant determination[101] and, as a practical matter, the chances of an agreement being reached are considered to be rather low.[102]

As a result, U.S.-German corporations of the type at issue have to depend on U.S. as well as on German law to grant them unilateral relief. German law allows corporations to deduct foreign taxes from their income,[103] but that option only reduces, and does not eliminate, the burden imposed by U.S. taxation. The IRC is more generous,

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98. Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G., S. TREATY DOC. NO. 101-10 (1990) [hereinafter Tax Treaty].

99. According to art. 7(1) of the Tax Treaty, the business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. Moreover, like art. 3(1)(d) MDTC, art. 3(1)(f) of the Tax Treaty provides that the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State. Article 4(1) of the Treaty provides that the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature.

100. *See also* FRIEDHELM JACOB ET AL., HANDBOOK ON THE 1989 DOUBLE TAXATION CONVENTION BETWEEN THE FEDERAL REPUBLIC OF GERMANY AND THE UNITED STATES OF AMERICA, art. 4, 53, ¶ 277 (2002) (noting that "[n]o tiebreaker rule is available if a corporation . . . is a dual resident").

101. Siehe Wolff, *USA, in* HELMUT DEBATIN & FRANZ WASSERMEYER, DOPPELBESTEUERUNG, Bd. VI, USA, Art. 4 USA ¶ 67 (on file with author).

102. Wolff, *supra* note 101, ¶ 67; *see also* KLAUS GROẞMANN, DOPPELT ANSÄSSIGE KAPITALGESELLSCHAFTEN IM INTERNATIONALEN STEUERRECHT 80 (1995) (on file with author) (noting that the national tax authorities may well fail to reach an agreement).

103. *See* EstG 2002, *supra* note 95, § 34 c. III; KStg 2002, *supra* note 96, § 26 VI 1. Foreign tax credits are only available to the extent that foreign taxes have been paid on foreign income. *See* KStG 2002, *supra* note 96, § 26 VI 1.

allowing the relevant corporation to reduce its tax burden by means of foreign tax credits.[104] But these foreign tax credits do not completely eliminate the problem at hand either. Needless to say, they do not save corporations from having to file an income tax return, a task that is all the more burdensome because the rules governing foreign tax credits are extremely complex[105] and because the U.S. rules on the computation of taxable income differ considerably from their German counterparts.[106] More important, U.S. law limits the availability of foreign tax credits in various ways.[107] Also, such credits are of limited use when the taxes to be paid in the United States in a specific case are higher than those that are due in the foreign jurisdictions.[108] That is particularly relevant in the case at hand, because Germany has a uniform corporate income tax rate of only 26.5 percent.[109] By contrast, the rates set by the IRC, while differing according to the size of a corporation's income, are often much higher:[110] While corporations pay only fifteen percent on the first $50,000 and twenty-five percent of the following $25,000, the tax rate is currently set at thirty-four percent for the portion of taxable income that falls between $75,000 and $10 million. To the extent that a corporation's income exceeds $10 million, the corporate income tax rate is set at thirty-five percent. As a result of the higher U.S. rates, the tax credits accorded to German-based firms incorporated in the United States will generally be of limited use. Hence, such firms will pay dearly for the use of U.S. corporate law.[111] In sum, as long as the state of incorporation doctrine remains the

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104. *See* 26 U.S.C.S. § 901 (Law. Co-op. 2003).

105. *See, e.g.*, Ann Duvall Alsobrook, Note and Comment, *Improving the Competitiveness of U.S. Multinational Corporations Through Changes to the Foreign Tax Credit*, 12 AM. U. J. INT'L L. & POL'Y 875, 877-78 (1997) (noting that "experts criticize the foreign tax credit limitation as one of the most unnecessarily complex provisions of United States international tax law").

106. For a comparison of German and U.S. rules on the computation of taxable income, see KAI M. REUSCH, DAS BILANZSTEUERRECHT DER VEREINIGTEN STAATEN VON AMERIKA 31-266 (2002) (on file with author).

107. For an overview, see Alsobrook, *supra* note 105, at 887-96.

108. Ironically, it is precisely the aim of the foreign tax credit system to ensure that corporations cannot avail themselves of lower taxes by operating their businesses abroad. The foreign tax credit system corresponds to the idea that the rules on international taxation should seek "capital export neutrality." *See* GARY C. Hufbauer, U.S. Taxation Of International INCOME 49 (1992). In other words, the decisions of multinational corporations about where to invest should not be distorted by tax considerations. That, of course, means that the decision about where to incorporate must be decisive for the amount of taxes to be paid.

109. *See* KSTG 2002, *supra* note 96, § 23(1).

110. *See* 26 U.S.C.S. § 11(b) (Law. Co-op. 2003).

111. It should be noted that an additional tax burden with regard to dividends can usually be avoided. That is because § 871(i) I.R.C. classifies dividends paid by U.S. corporations as foreign income to the extent that the eighty-percent foreign business requirement of section 861(c)(1) I.R.C. is met. *See* 26 U.S.C.S. § 871(i) (Law. Co-op. 2003).

only mechanism for exercising free choice, national rules on corporate taxation constitute a formidable obstacle to the transatlantic market for corporate charters.

III. THE STATUTORY APPROACH TO FREE CHOICE

To avoid the above-described drawbacks of the state of incorporation doctrine, it is not necessary to abolish that doctrine. Rather, both federal law in the United States and Community law in Europe should complement the state of incorporation doctrine by allowing corporations to choose the applicable state law in their articles of incorporation. If no choice is made, the general business corporation law of the state of incorporation should apply as a default.

Such a statutory approach to free choice would provide considerable practical benefits: Corporations could choose the law of a jurisdiction without being exposed to litigation in that state. In addition, double taxation would be avoided. European corporations, moreover, could choose U.S. corporate law without having to obey the U.S. rules on securities regulation. It should also be noted that the approach suggested above minimizes federal interference. In particular, it does not require or allow corporations to incorporate directly under a federal statute.

A. *Franchise Fees*

Of course, one problem has so far been avoided in this Article. If one assumes that state competition for corporate charters is beneficial, the federal legislator has to ensure that the incentives for states to compete are not diminished. That, of course, is precisely the risk that may occur if corporations are given the right to choose the applicable corporate law in their articles of incorporation. To the extent that U.S. states compete,[112] the most important incentive underlying that competition is the desire to maximize revenues from

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112. The extent of state competition in corporate law is in dispute. Several voices have recently suggested that Delaware may be the only U.S. state that seriously tries to attract corporate charters. *See* Bebchuk & Hamdani, *supra* note 7, at 580-82; Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002) [hereinafter Kahan & Kamar, *The Myth*]. Others have doubted the accuracy of that assessment. *See, e.g.*, Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQ. L. 387, IV.B., text accompanying note 313 (2001) (noting that Delaware is not the only state to continually revise its corporate charters, that Nevada explicitly tried to become the "Delaware of the West," and that Delaware would not have to modernize its corporate law regularly if it did not have to fear any competition).

franchise fees.[113] If corporations can avail themselves of another state's corporate law without incorporating in that state, an important incentive to compete is undermined. The same reasoning applies with regard to the Member States of the European Community. As the author has explained in another article, Community law presently prevents the Member States from imposing franchise taxes on corporations whose real seat is located elsewhere.[114] But if the underlying rules were changed, franchise fees could become as important an incentive to compete as they are in the United States.[115]

Against this background, federal law could require the states to force domestic corporations to pay franchise fees to those states whose law is declared applicable. The amount to be paid could be determined by the state whose law is declared applicable (hereinafter, "selected state"). That way, it would not matter from the perspective of a selected state whether a corporation incorporates there or whether it declares the law of that state to be applicable in its articles of incorporation.[116]

Technically, such a system could be organized in a way that minimizes the burden on the states involved. Federal law could simply prescribe that if an organization's articles of incorporation make an explicit reference to the law of another jurisdiction, the state of incorporation must not file the relevant articles of incorporation unless the corporation provides a certificate issued by the selected state, stating that all franchise fees have been paid. Moreover, the state of incorporation could be required to dissolve the corporation as soon as the selected state claims that the corporation has not paid the

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113. *See* Kahan & Kamar, *The Myth*, *supra* note 112, at 697-98 (estimating the additional income that the Delaware Bar derived from the charter business in 2001 to be around $90 million and pointing out that the franchise fees that Delaware collected that same year amounted to around $600 million).

114. *See* Dammann, *supra* note 1, at 521.

115. *Id.* at 524-33.

116. Indeed, one may even consider a rule according to which the selected state is prohibited from imposing higher franchise fees on those corporations selecting that state's law in their articles of incorporation than on those corporations that actually incorporate in the state in question. That way, states with attractive corporate law would be prevented from circumventing the statutory approach suggested in this Article. But it is unclear whether states with attractive corporate law would have a sufficient incentive to undermine the statutory approach to free choice in the first place. After all, that approach will increase corporate mobility and hence serve the interests of those states that boast attractive corporate law norms. At most, states with popular corporate law might oppose the statutory approach to free choice, because it might hurt the interests of the local bar by eliminating the need for corporations to litigate in the selected state. But it is unclear to what extent the local bar would actually suffer a financial loss because of the approach suggested in this Article. Most corporations may still choose to incorporate in the selected state, and the statutory approach may be used primarily by those corporations whose internal affairs would otherwise be governed by the law of the real seat state.

franchise taxes it owes. That way, the state of incorporation would be free of the burden of calculating franchise fees and making sure that they are paid regularly.

An obvious criticism of this system would be that an explicit reference to another state's law can easily be circumvented. For example, instead of referring to a particular provision in the law of another state, the text of the relevant provision could simply be integrated into the articles of incorporation. That objection, however, is unconvincing. Such a course of conduct does not grant corporations the specific advantage that comes with a "dynamic" reference—namely, the incorporation of present and future case law. Moreover, it should be recalled that even under the present system, corporations can easily incorporate the wording of Delaware's General Corporation Law in their articles of incorporation without having to incorporate in Delaware.[117] The existence of that loophole may be undesirable, because it deprives states of some of the benefits that result from their corporate law rules and thereby reduces the incentive for states to maximize the efficiency of their corporate law.[118] But this is not a problem that is particular to the statutory approach to free choice.

B. *Changing the Selected State*

To increase corporate mobility, the federal legislator should also take the necessary precautions to ensure that corporations can freely change the selected state without being subject to an "exit tax" by the state whose law was initially chosen. Similarly, corporations should be able to merge with corporations governed by the law of another jurisdiction without being subject to additional taxes.

The relevance of this problem is easily explained. Traditionally, exit taxes on corporations trying to reincorporate in another jurisdiction have been a major obstacle to corporate mobility. To be sure, this problem does not occur in the U.S. charter market, because the Internal Revenue Code allows for reincorporation decisions to be structured as tax-free reorganizations under § 368(a).[119] The situation is more problematic in the European and transatlantic charter markets, however. Consider, first, the situation in the Community. As is explained in more detail in another article,[120]

117. *See, e.g.*, NEV. REV. STAT. § 78.037 (2003) (providing that articles of incorporation "may also contain any provision, not contrary to the laws of the state," for the management of the business, dividing powers, etc.).

118. A similar problem was pointed out years ago by Ian Ayres: U.S. states may have an insufficient incentive to innovate, because other states can easily copy any innovation. *See* Ayres, *Supply-Side Inefficiencies*, *supra* note 7, at 549 (considering the possibility of a federal rule that prevents states from imitating the law of sister states for a limited number of years in order to increase the incentive for innovation).

119. *See, e.g.*, Subramanian, *supra* note 4, at 1802.

120. *See* Dammann, *supra* note 1, at 22-23.

European corporations often cannot reincorporate in another Member State without having their hidden assets taxed by their old state of incorporation. To be sure, a directive adopted in 1990 prohibits the states from taxing a corporation's hidden reserves in case of a cross-border merger between two or more European corporations.[121] To the extent that corporations reincorporate by merging with a newly formed corporation in the desired state of incorporation, they have nothing to fear. But the practical importance of the latter rule is diminished by the fact that such mergers are not always possible. Some Member States including Germany[122] and Austria[123] do not allow cross-border mergers. Other Member States such as Spain,[124] the United Kingdom,[125] Portugal,[126] Italy,[127] and possibly Ireland[128] allow cross-border mergers in principle, but the legal situation often suffers from a lack of clarity.[129]

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121. *Cf.* Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets, and exchanges of shares concerning companies of different Member States, Art. 4(1), 1990 O.J. (L 225) 1, 2 ("A merger or division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes.").

122. *See, e.g.*, Herbert Kronke, *Deutsches Gesellschaftsrecht und grenzüberschreitende Strukturänderungen [German Company Law and Structural Changes Across Borders]*, 23 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 26, 36 (1994) (on file with author); Georg Maier-Reimer, *§ 120*, in UMWANDLUNGSGESETZ 1216, ¶ 19 (Johannes Semler & Arndt Stengel eds., 2003) (on file with author).

123 *See, e.g.*, THOMAS RATKA, GRENZÜBERSCHREITENDE SITZVERLEGUNG VON GESELLSCHAFTEN 223 (2002) (on file with author).

124. *See* AXEL STEIGER, GRENZÜBERSCHREITENDE FUSION UND SITZVERLEGUNG VON KAPITALGESELLSCHAFTEN INNERHALB DER EU NACH SPANISCHEM UND PORTUGIESISCHEM RECHT [CROSS-BORDER MERGERS AND TRANSFERS OF DOMICILE WITHIN THE EU UNDER SPANISH AND PORTUGUESE LAW] 82 (1997) (on file with author).

125. *See* JOHN H. FARRAR ET AL., FARRAR'S COMPANY LAW 754 (4th ed. 1998); FREDERICK GILLESSEN, EUROPÄISCHE TRANSNATIONALE SITZVERLEGUNG UND FUSION IM VEREINIGTEN KÖNIGREICH UND IN IRLAND [EUROPEAN CROSS-BORDER TRANSFERS OF THE CORPORATE DOMICILE AND MERGERS IN THE UNITED KINGDOM AND IN IRELAND] 385 (2000) (on file with author); Kurt Lipstein, *One Hundred Years of Hague Conference on Private International Law,* 42 INT'L. & COMP. L.Q. 553, 630 (1993).

126. *See* STEIGER, *supra* note 124, at 215.

127. *See* HEIKE BRUHN, NIEDERLASSUNGSFREUNDLICHE SITZVERLEGUNG UND VERSCHMELZUNG ÜBER DIE GRENZE NACH ITALIENISCHEM RECHT [THE ESTABLISHMENT-FRIENDLY TRANSFER OF THE SEAT AND THE CROSS-BORDER MERGER UNDER ITALIAN LAW] 266-67 (2002) (on file with author).

128. With regard to Irish law, the situation does not seem entirely clear. Irish statutory law does not provide for the possibility of a transnational merger. *See* GILLESSEN, *supra* note 125, at 435-36. But it has been suggested that such a merger may be possible anyway. *See id.*

129. Thus, in the United Kingdom, there seems to be no case law dealing with this issue. *See id.* at 385. Similarly, it has been suggested that the Spanish and Portuguese rules on cross-border mergers may be so fraught with uncertainty as to preclude such mergers in practice. *See* STEIGER, *supra* note 124, at 274.

In the transatlantic context, the situation is even bleaker. The above-mentioned U.S. rules on tax-free reorganizations do not apply if U.S. corporations merge with foreign ones.[130] Similarly, the above-mentioned Community directive on cross-border mergers does not apply to mergers between European and U.S. corporations.[131]

It should be noted, in this context, that the above-described rules on the taxation of cross-border mergers cannot be advanced as an argument against the state of incorporation doctrine. After all, just as jurisdictions impose taxes on cross-border mergers, they may decide to impose taxes when a domestic corporation seeks to merge with a corporation governed by the law of another jurisdiction or when such a corporation changes the content of the choice-of-law provision in its articles of incorporation. It is precisely because of this possibility that the Community legislator as well as the federal legislator in the U.S. should adopt the rules on taxation suggested above.

IV. THE PRACTICAL RELEVANCE OF THE STATUTORY APPROACH

The question remains, of course, whether the adoption of the statutory approach suggested in this Article would likely lead a significant number of corporations to choose a corporate law regime other than the one they are governed by under the present system. While that question may seem difficult to resolve in a definitive manner with regard to the U.S. charter market, and even with regard to the European one, it calls for an affirmative answer as far as the transatlantic charter market is concerned.

At present, such a charter market does not exist.[132] But there is

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130. *See* 26 U.S.C. § 367(a) (2003).

131. *Cf.* Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets, and exchanges of shares concerning companies of different Member States, Art. 1(1), 1990 O.J. (L 225) 1, 2 ("Each Member State shall apply this Directive to mergers, divisions, transfers of assets and exchanges of shares in which companies from two or more Member States are involved."); Arndt Stengel, *Anh. § 77, in* UMWANDLUNGSGESETZ 792, ¶ 5 (Johannes Semler & Arndt Stengel eds., 2003) (noting that the directive does not apply to mergers involving corporations from third countries).

132. Joachim Berndt, *Die Rechtsfähigkeit US-amerikanischer Gesellschafen im Inland [The Legal Capacity of U.S. Corporations in Germany]*, JURISTENZEITUNG [JZ] 187, 188 (1996) (on file with author). Berndt claims that the creation of a Delaware corporation is often used to avoid German corporate law. *Id.* But he does not cite any sources in support of this claim. Indeed, given that German courts traditionally have not recognized the legal capacity of such corporations, see *infra* text accompanying notes 140-59, it is highly unlikely that a significant number of German firms have incorporated in Delaware. It should be mentioned, though, that countless fraudulent advertisements recommend incorporation in Delaware to European firms as way to avoid corporate income taxes as well as to conceal existing criminal records. The relevant advertisements, which can easily be found on the internet, typically point out

reason to believe that it would develop if corporations could freely choose the applicable corporate law in their articles of incorporation. That the statutory approach to free choice removes a whole series of obstacles to the transatlantic charter market has become clear in the course of this Article. Corporations could choose the law of a jurisdiction on the other side of the Atlantic without being exposed to litigation in that jurisdiction. Additional taxes on corporate income would be avoided. European corporations, moreover, could prevent the application of U.S. securities law.

Against this background, the only question is whether the obstacles thus eliminated are decisive in explaining the present lack of a transatlantic charter market or whether that phenomenon can be explained by factors that are unrelated to the weaknesses of the state of incorporation doctrine. In fact, there are indeed additional considerations that contribute to the absence of a transatlantic charter market. However, while these additional factors are far from irrelevant, they are insufficient to explain the general unwillingness to incorporate in a jurisdiction on the other side of the Atlantic. For the sake of simplicity, the following analysis will focus on U.S. and German firms. In large part, however, the relevant reasoning can be transferred to other European countries.

It is not difficult to explain why U.S. firms have never sought to incorporate in Germany. Corporations cannot incorporate under German law unless their real seat is located in Germany.[133] *Centros*, *Überseering*, and *Inspire Art* have not changed this fact. These rulings only govern the rights that foreign corporations have vis-à-vis the real seat state.[134] By contrast, they do not restrict the right of the Member States to define the preconditions under which domestic

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that disclosure requirements regarding shareholders are far less restrictive in the United States than they are in Europe. They also praise Delaware as a tax haven, claiming that Delaware corporations operated in other countries do not have to pay income taxes. The fact that both the real seat state's income taxes and U.S. federal income taxes will apply is not mentioned.

133. *Cf.* BGHZ 51, 27 (28) (holding that a corporation's internal affairs are governed by the law of the real seat state).

134. This conclusion became abundantly clear in the *Überseering* decision. There, the Court of Justice explicitly distinguished the facts underlying *Überseering* from those underlying the famous *Daily Mail* judgment by pointing to the fact that *Daily Mail* concerned the rights of a domestic corporation vis-à-vis its state of incorporation, whereas *Überseering* concerned the rights of foreign corporations vis-à-vis the real seat state. *See* Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919, ¶ 62 (2002).

> It must be stressed that, unlike Daily Mail and General Trust, which concerned relations between a company and the Member State under whose laws it had been incorporated . . . the present case concerns the recognition by one Member State of a company incorporated under the law of another Member State.

corporations can incorporate.[135] In any case, *Centros*, *Überseering*, and *Inspire Art* are based on the Freedom of Establishment, and that freedom does not apply to the situation at hand.[136] Thus, the question remains why there seem to be practically no German firms incorporating in the United States. A lack of attractiveness on the part of U.S. corporate law can hardly be the reason. After all, by incorporating in the United States, German corporations could avoid both minimum capital requirements and the much-loathed rules on codetermination.[137] If one disregards the various obstacles created by the state of incorporation doctrine, only three potential explanations remain: Germany's traditional adherence to the real seat doctrine, the inability to reincorporate between the two countries, and German firms' ability to choose U.K. law instead of U.S. law.

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135. *See id.* ¶ 40.

> Since companies are creatures of national law, they must continue to observe the requirements laid down by the legislation of their State of incorporation. Daily Mail and General Trust therefore formally acknowledge the right of the Member State of incorporation to set rules on the incorporation and legal existence of companies in accordance with its rules of private international law.

Id.

136. *Cf.* T.E.C., *supra* note 10, art. 48(1).

> Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

137. The various German statutes on codetermination explicitly list the organizational forms to which they are applicable, and they only name certain German organizational forms such as the Aktiengesellschaft (stock corporation) or the Gesellschaft mit beschränkter Haftung (Limited Liability Company). *See* § 1(1)(1) Gesetz über die Mitbestimmung von Arbeitnehmern (MitbestG), v. 4.5.1976 (BGBl. I S.1153); § 1 Gesetz zur Ergänzung des Gesetzes über die Mitbestimmung der Arbeitnehmer in den Aufsichtsraten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie (MitBestErgG), v. 7.8.1956 (BGBl. I S.707); § 76(1) Betriebsverfassungsgesetz 1952 (BetrVG), Oct. 1952 (BGBl. I S.681); § 2(1) Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsraten und Vorstanden der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie (Montan-MitbestG), v. 21.5.1951 (BGBl. I S.347). Moreover, under the prevailing view, the relevant statutes cannot be applied to foreign corporations by analogy. *See, e.g.*, THOMAS RAISER, MITBESTIMMUNGSGESETZ [CODETERMINATION ACT] § 1, ¶ 10 (4th ed. 2002) (on file with author); Peter Ulmer, *Schutzinstrumente gegen die Gefahren aus der Gewerbstätigkeit inländischer Zweigniederlassungen von Kapitalgesellschaften mit fiktivem Auslandssitz [Protective Mechanisms Against the Risks Resulting from the Activities of Domestic Branch Offices of Pseudo-Foreign Corporations]*, 54 JURISTENZEITUNG [JZ] 662, 663 (1999) (on file with author).

A. *The Real Seat Doctrine*

First and foremost, one might be tempted to explain the unwillingness of German firms to incorporate in the United States by Germany's traditional adherence to the real seat doctrine. Germany has historically refused to recognize the legal personality of a corporation formed under foreign law but having its real seat in Germany.[138] Instead, such organizations were treated as partnerships, and all their shareholders were subject to unlimited liability.[139] Upon closer examination, that explanation proves unsatisfying because it has long been unclear to what extent Germany can apply the real seat rule to corporations incorporated in the United States. Article XXV of the Treaty of Friendship, Commerce and Navigation (TFCN) between the Federal Republic of Germany and the United States provides that "companies constituted under the applicable laws and regulations within the territories of either Party shall be deemed companies thereof and shall have their juridical status recognized within the territories of the other Party."[140]

To be sure, it is not entirely clear whether the TFCN can be read as embracing the state of incorporation doctrine. There are two main considerations that may undermine such an assumption. First, what the duty to "recognize" the "judicial status" of the foreign corporation entails is controversial. Basically, three views can be distinguished in this context. Some commentators believe that the relevant provision only refers to the question of who enjoys the various rights accorded by the TFCN and is without relevance to the corporate conflict of laws.[141] Others believe that the TFCN prescribes the state of incorporation doctrine, but only with regard to the recognition of the legal personalities of foreign corporations.[142] Under that view, a

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138. *See, e.g.*, Carsten Thomas Ebenroth & Achim Sura, *Das Problem der Anerkennung im Internationalen Gesellschaftsrecht – Feststellung der Rechtsfähigkeit und Bestimmung des Personalstatuts* [*The Problem of Recognition the Conflict of Law Rules Regarding Corporations - Confirmation of Legal Capacity and Determination of Personal Statute*], 43 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALS PRIVATRECHT [RABELSZ] 315, 317 (1979); Gerfried Fischer, *Haftung für Scheinauslandsgesellschaften (zu LG Stuttgart, 31.7.1989 – 7 O 64/89)* [*The Liability for Debts of Pseudo-Foreign Corporations (A Comment on LG Stuttgart 31.7.1989 – 7 O 64/89)*], 11 PRAXIS DES INTERNATIONALEN PRIVATRECHTS [IPRAX] 100, 101 (1991) (on file with author).

139. *See* sources cited *supra* note 144.

140. Treaty of Friendship, Commerce and Navigation, Oct. 29, 1954, U.S.-F.R.G., 7 U.S.T. 1839, art. 25.

141. *See, e.g.*, GERHARD KEGEL, INTERNATIONALES PRIVATRECHT 427 (7th ed. 1995) (on file with author); Berndt, *supra* note 132, at 190-91.

142. *See, e.g.*, Werner F. Ebke, *Unternehmensrecht und Binnenmarkt—E pluribus unum?* [*The Law of the Enterprise and the Internal Market—E Pluribus*

corporation formed in the United States will be recognized as a legal person in Germany, but as long as its real seat is in Germany, German law will apply to its internal affairs.[143] Finally, it has been argued that the TFCN completely embraces the state of incorporation doctrine with regard to U.S. corporations (i.e., that the Contracting States are bound to apply the corporate law of the jurisdiction where the relevant organization was formed).[144]

The second obstacle also comes in the guise of a narrow interpretation of Article XXV of the TFCN. Some voices have suggested that despite the TFCN's wording, a "genuine link" has to exist between the state of incorporation and the corporation itself.[145] The mere fact that a corporation is incorporated in a Contracting State and may have a mailbox address in that state, they argue, cannot suffice for the application of Article XXV.[146]

Unum?], 62 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALS PRIVATRECHT [RABELSZ] 195, 211 (1998) (noting that the relevant treaty provision does not replace the real seat rule as a whole); *see also* Bernhard Großfeld & Susanne Erlinghagen, *Internationales Unternehmensrecht und deutsche unternehmerische Mitbestimmung [International Corporate Law and German Codetermination]*, 48 JURISTENZEITUNG [JZ] 217, 224-25 (1993) (on file with author) (arguing that the TFCN prescribes at most the internal affairs doctrine with regard to the legal capacity of corporations but leaving open the possibility that the TFCN does not concern conflict of laws questions at all).

143. *See* sources cited *supra* note 148.

144. *See, e.g.*, Carsten Thomas Ebenroth & Birgit Bippus, *Die Anerkennungsproblematik im Internationalen Gesellschaftsrecht [The Problem of Recognition in International Corporate Law]*, 41 Neue Juristische Wochenschrift [NJW] 2137, 2142 (1988); Carsten Thomas Ebenroth & Thomas J. Dillon, *Gaining the Competitive Edge: Access to the European Market Through Bilateral Commercial Treaties and Taxation Strategies*, 28 TEX. INT'L L.J. 269, 283 (1993) (noting that German courts must apply U.S. law to the internal affairs of U.S. corporations); Wulf-Henning Roth, *Der Einfluß des Europäischen Gemeinschaftsrechts auf das Internationale Privatrecht [The Influence of European Community Law on the Rules Governing the Conflict of Laws]*, 55 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALS PRIVATRECHT [RABELSZ] 623, 651 (1991) (stressing in particular that Art. 25 of the TFCN allows German firms to avoid the rules on codetermination); Susan Wessels & Hans-Jörg Ziegenhain, *Sitz und Gründungstheorie im internationalen Gesellschaftsrecht [Real Seat Doctrine and State of Incorporation Doctrine in International Corporate Law]*, 77 GMBH-RUNDSCHAU [GMBHR] 423, 431 (1988) (on file with author); *see also* Hartwin Bungert, *Rechtsfähigkeit US-amerikanischer Kapitalgesellschaften ohne geschäftlichen Schwerpunkt in den USA [Legal Capacity of U.S. Corporations without an Effective Place of Management in the USA]*, 49 WERTPAPIER-MITTEILUNGEN [WM] 2125, 2131 (1995) (on file with author) (suggesting that a U.S. corporation's internal affairs are governed by U.S. corporate law, but defining the concept of internal affairs narrowly so as to exclude, for example, rules on legal representation).

145. *Cf.* Berndt, *supra* note 132, at 190-91.

146. OLG Düsseldorf, Urt. v. 15.12.1994, 16 PRAXIS DES INTERNATIONALEN ZIVIL- UND VERFAHRENSRECHTS [IPRAX] 130-31 (1996); Carsten Thomas Ebenroth et al., *Die Auswirkungen des genuine-link-Grundsatzes auf die Anerkennung US-amerikanischer Gesellschaften in Deutschland*, 16 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 972, 974 n.24 (1995) (on file with author); Carsten Thomas

This said, the two above-mentioned attempts at a restrictive interpretation of the TFCN are insufficient to explain why German firms have not even attempted to use the relevant treaty provision as a means of incorporating under U.S. corporate law. That is because the highest German court in civil law matters, the Bundesgerichtshof, has never adopted the restrictive interpretations suggested above.

Consider first, the issue of whether the TFCN deals with the question of which corporate law regime is to apply. The most restrictive view—namely, the position that the TFCN does not relate to the conflict of laws at all, has sometimes been adopted by lower courts.[147] But when it finally reached the Bundesgerichtshof in 2003, it was flatly rejected.[148] The Bundesgerichtshof did not, in that decision, address the question of whether the TFCN prescribes the state of incorporation doctrine with regard to all other matters as well. While that question has sometimes been answered in a negative fashion by lower courts,[149] the Bundesgerichtshof might well come to a different conclusion.

Similarly, the Bundesgerichtshof has never addressed the question of whether the TFCN applies only to those foreign corporations that have a genuine link with the state of incorporation. At least two lower courts have taken this view,[150] but they have received sharp criticism in the legal literature.[151]

Ebenroth & Birgit Bippus, *Die staatsvertragliche Anerkennung ausländischer Gesellschaften in Abkehr von der Sitztheorie* [*The Bilateral Recognition of Foreign Corporations in Departure from the Real Seat Doctrine*], 41 DER BETRIEB 842, 845 (1988); Carsten Thomas Ebenroth & Andreas Willburger, *Kurzkommentar zu OLG Düsseldorf EWiR § 11 GmbHG 1/95, 583* [*A Brief Comment on OLG Düsseldorf EWiR § 11 GmbHG 1/95, 583*], 11 ENTSCHEIDUNGEN ZUM WIRTSCHAFTSRECHT [EWIR] § 11 GMBHG 583, 584 (1995) (on file with author).

147. *See* OLG Hamm, GMBH-RUNDSCHAU 302 (2003); OLG Düsseldorf, Urt. v. 1.10.1997 – 15 U 173/96, juris.

148. *See* BGH, 57 WERTPAPIER-MITTEILUNGEN [WM] 699, 700 (2003).

149. *See* LG Hagen, 3 PRAXIS DES INTERNATIONALEN PRIVATRECHTS [IPRAX] 35, 36 (1983). By contrast, the OLG Naumburg seems to assume that art. 25 of the TFCN imposes the state of incorporation doctrine both with regard to a corporation's legal capacity and with regard to all other internal matters. *See* OLG Naumburg, Urt. v. 19.12.1995 – 7 U 146/95, juris, II.1.b.

150. OLG Düsseldorf, Urt. v. 15.12.1994, 16 PRAXIS DES INTERNATIONALEN ZIVIL- UND VERFAHRENSRECHTS [IPRAX] 130-31 (1996); OLG Naumburg, Urt. v. 19.12.1995 – 7 U 146/95, juris, II.2.

151. *See, e.g.*, Hartwin Bungert, *Sitzanknüpfung für Rechtsfähigkeit von Gesellschaften gilt auch nicht mehr im Verhältnis zu den USA* [*Real Seat Rule Does Not Govern the Legal Capacity of Corporations in Relation to the USA Either*], 37 DER BETRIEB [DB] 1043, 1044 (2003) (on file with author); Michael J. Ulmer, *Die Anerkennung US-amerikanischer Gesellschaften in Deutschland* [*The Recognition of U.S. Corporations in Germany*], 16 PRAXIS DES INTERNATIONALEN ZIVIL- UND VERFAHRENSRECHTS [IPRAX] 100, 103 (1996) (on file with author); Wessels & Ziegenhain, *supra* note 144, at 431.

Against that background, any attempt to explain the lack of a transatlantic charter market between Germany and the United States on the basis of the real seat rule must fail. If the real seat doctrine were the decisive obstacle for German corporations wishing to incorporate in the United States, then surely one could have expected the relevant legal issues to be clearly resolved by now.

B. *The Inability to Reincorporate*

One could also argue that the unwillingness of German firms to incorporate in the United States is due to the inability to reincorporate between the two countries: at present, German law does not allow mergers between German and foreign corporations.[152] Neither does German law allow domestic corporations to transfer their statutory seat to another jurisdiction, while retaining their real seat in Germany.[153] Similarly, while German law does not prevent foreign corporations from transferring their statutory seat to Germany,[154] the German legal system will not recognize them as German corporations unless they are newly formed.[155] As a result, foreign corporations cannot reincorporate in Germany, and German corporations cannot reincorporate abroad. In both cases, of course, a new corporation can be formed in the desired jurisdiction. But given the lack of rules allowing for transnational mergers, the firm's hidden assets would be subject to taxation.[156]

This Article expresses no doubt about the importance of these rules, but the inability to migrate from Germany to the United States or vice versa cannot explain the complete unwillingness of German firms to incorporate in the United States. After all, if the above-described drawbacks of the state of incorporation rule are

152. That is true regardless of whether the surviving corporation is to be the German or the foreign one. *See, e.g.*, Kronke, *supra* note 128, at 36; Maier-Reimer, *supra* note 128, at 1216, ¶ 19. A few scholars hold a different view vis-à-vis intra-European mergers. *See, e.g.*, Marcus Lutter, *Umstrukturierung von Unternhemen über die Grenze: Versuch eines Resumes [Cross-border Corporate Restructuring: Attempt at a Summary]*, 23 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 87, 91 (1994) (suggesting, with a view to the Freedom of Establishment, that German law should be interpreted in such a way as to allow cross-border mergers).

153. *See, e.g.*, BGHZ 29, 320 (328); BGHZ 19, 102 (105); OLG Hamm, 13 NEUE JURISTISCHE WOCHENSCHRIFT-RECHTSPRECHUNGSREPORT [NJW-RR] 615, 615 (1998).

154. *See, e.g.*, STEIGER, *supra* note 124, at 53.

155. *See, e.g.*, *id.*; BRUHN, *supra* note 127, at 35.

156. That consequence occurs regardless of whether a German corporation decides to reincorporate in the United States or whether a U.S. corporation decides to reincorporate in Germany. As long as the corporation to be dissolved has been operating its business in Germany and has therefore been taxed in Germany on its worldwide profits, any liquidation of the corporation will lead to the corporation's hidden assets being taxed. This is true regardless of the nationality of the corporation. *See* § 11 Körperschaftsteuergesetz, v. 3.21.1991 (BGBl. I, S.831).

disregarded, the risks that result from having to remain incorporated in the United States are limited. In particular, corporations need not fear that the U.S. jurisdiction they have chosen will make use of their inability to reincorporate in Germany in order to exploit them. Apart from the fact that such a course of action would be highly damaging to the reputation of the relevant jurisdiction in the market for corporate charters, the corporations at issue could always reincorporate in another U.S. jurisdiction. Moreover, there is another reason to believe that the inability to return to the real seat state at a later point is not behind the unwillingness of German-based firms to incorporate in the United States: the same obstacle exists between the United Kingdom and the Netherlands,[157] yet that fact has not deterred Dutch firms from forming U.K. companies in large numbers.[158] Further, not all corporations have or expect to have hidden reserves that might prevent them from reincorporating in another jurisdiction at low cost.

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157. Neither U.K. nor Dutch law allows corporations to transfer their statutory seat to another jurisdiction. With regard to Dutch law, see Levinus Timmerman, *Sitzverlegung von Kapitalgesellschaften nach niederländischem Recht und die 14. EU-Richlinie [The Transfer of the Corporate Seat under Dutch Law and the 14th Directive]*, 28 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 147, 152-53 (1999) (on file with author). Only in cases of emergencies, such as wars or revolutions, are Dutch corporations allowed to transfer their statutory seat to another state. *See id.* at 154. It should also be noted that Dutch law does not allow foreign corporations to enter into the scope of application of Dutch corporate law by transferring their statutory seat to the Netherlands. *Id.*

Moreover, U.K. company law does not allow corporations to transfer their statutory seat to another jurisdiction either. *See, e.g.*, Todd v. Egyptian Land and Investment Co., [1228] 1 K.B. 152, 173; Gasque v. I.R.C., [1940] 2 K.B. 80, 84; Carl Zeiss Stiftung v. Rayner & Keeler & others (No. 3), [1970] 1 Ch. 506, 544; J.G. COLLIER, CONFLICT OF LAWS 61 (2nd ed. 1994); DICEY AND MORRIS ON THE CONFLICT OF LAWS 1104 (Lawrence Collins ed., 12th ed. 1993); ALBERT FARNSWORTH, THE RESIDENCE AND DOMICIL OF CORPORATIONS 230 (1939); P.M. NORTH & J. J. FAWCETT, CHESHIRE & NORTH'S PRIVATE INTERNATIONAL LAW 174 (12th ed. 1992).

In addition, mergers between U.K. companies and Dutch companies do not seem to be a realistic option. To be sure, U.K. law has been interpreted by some to allow cross-border mergers. *See* GILLESSEN, *supra* note 125, at 385. But the courts do not seem to have decided on the admissibility of such a merger. *See id.* Moreover, Dutch law expressly prohibits cross-border mergers with foreign corporations. *See* Timmermann, *supra*, at 155.

158. *See* EVA-MARIA KIENINGER, WETTBEWERB DER PRIVATRECHTSORDNUNGEN IM EUROPÄISCHEN BINNENMARKT 198 (2002) (on file with author) (noting that the Netherlands was forced to restrict the state of incorporation doctrine because of the "massiven Abwanderung inländischer kleiner und mittlerer Unternehmen in ausländische Rechtsformen, insbesondere die der englischen company limited. . . . [massive migration of small and medium-size businesses toward foreign organizational forms, particularly toward that of the English company limited. . . .]").

C. *The Demand for U.S. Corporate Law*

Finally, one could claim that there is simply no demand for U.S. corporate law among German firms, because they can turn to U.K. company law instead. Indeed, today that reasoning has considerable weight. Given *Centros*, incorporation in the United Kingdom is a far more reliable way of avoiding the German rules on minimum capital requirements and codetermination than incorporation in the United States can be. But it should be noted that the *Centros* decision was only adopted in 1999.[159] Before that, incorporation in the United Kingdom was not an option for German firms, given that no treaty between Germany and the United Kingdom has ever required the application of the state of incorporation doctrine.[160] In fact, the only other such treaty was concluded with Spain.[161] Yet no reports of German corporations migrating to Spain to avoid German law have ever surfaced. Hence, to the extent that German firms were interested in a more flexible corporate law, one would have expected them to incorporate in the United States rather than in the United Kingdom.

In sum, therefore, one has to conclude that the shortcomings of the state of incorporation doctrine truly matter, as far as the transatlantic charter market is concerned. There may be other factors that contribute to the unwillingness of European and U.S. firms to incorporate in a jurisdiction on the other side of the Atlantic. But these other obstacles are per se insufficient to explain the lack of a transatlantic charter market. Rather, one can only conclude that the inexistence of a transatlantic charter market is largely the consequence of the various shortcomings of the state of incorporation doctrine.

V. POTENTIAL JUSTIFICATIONS FOR THE PRESENT SYSTEM

So far, this Article has shown that the state of incorporation doctrine possesses a number of drawbacks that may discourage corporations from choosing the corporate law they find most efficient. First, the doctrine exposes corporations to the risk of litigation in the state of incorporation. Second, it forces European firms willing to

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

160. *See, e.g.*, Ebenroth et al., *supra* note 146, at 974-75; Brigitte Knobbe-Keuk, *Umzug von Gesellschaften in Europa* [*Migration of Companies in Europe*], 154 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT [ZHR] 325, 330 (1990) (on file with author).

161. *Id.*

incorporate in the United States to accept the application of U.S. securities law. Finally, in the transatlantic charter market, it may burden corporations willing to choose another state's law with adverse consequences in the field of taxation. Moreover, it has been shown that these drawbacks really matter, at least in the transatlantic context. But that does not necessarily prove that retaining the state of incorporation doctrine as the only mechanism for exercising free choice is on the whole inefficient. Rather, the question remains whether there are any advantages to such a course of action that make up for the above-described shortcomings.

A. *Transparency*

In this context, one may first point to the issue of transparency. The state of incorporation doctrine, it seems, makes it particularly simple for potential shareholders, third parties, and courts to identify the applicable state law.[162] That same degree of transparency could not be attained, one could argue, if corporations were able to determine the applicable state law in their articles of incorporation. But that line of reasoning does not carry far. With regard to potential investors, the alleged gains in transparency can be minimal at best. After all, capital markets should not find it substantially more difficult to take notice of an express choice-of-law provision in the articles of incorporation than to consider the question of where a corporation is incorporated. Courts, too, will not be substantially

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162. It should be noted, in this context, that the transparency argument is typically advanced against the state of incorporation rule when the latter is compared to the real seat rule: Under the real seat rule, a third party creditor knows which corporate law regime governs a corporation's internal affairs. Under the state of incorporation rule, by contrast, third party creditors are put at a disadvantage because they may not know where the corporation is incorporated, and even if they do, they may not be familiar with the law of that jurisdiction. *See, e.g.*, Wulf-Henning Roth, *From Centros to Überseering: Free Movement of Companies, Private International Law, and Community Law*, 52 INT'L & COMP. L.Q. 177, 202-03 (2003) (defending the real seat doctrine on the grounds that it lowers the information costs that third parties face in becoming informed regarding the legal rules governing the corporation). That reasoning, however, is just as unpersuasive as the argument presented and criticized in the text. The state of incorporation is easy to ascertain. Hence, to the extent that the corporation's business partners face additional information costs in dealing with foreign corporations, they can demand adequate compensation or—more realistically—refuse to deal with the corporation in question. Only involuntary creditors may need additional protection. That problem, however, can be solved more easily and more effectively by ensuring that the rules governing the rights of tort victims are not subject to free choice in the first place. *Cf.* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1921-23 (1991) (arguing that "any state should be able to adopt unlimited shareholder liability for corporate torts . . . for application to any tort claim to which the state's tort law applies, regardless of the state of incorporation of the corporate defendant").

burdened by the need to take account of the content of the articles of incorporation.

That leaves the situation of third party creditors. For practical reasons, such as the relative unimportance of their transactions with the corporation, some of these creditors will not be willing or able to consult the corporation's articles of incorporation ex ante. Such parties, one could argue, are the true victims of the statutory regime suggested in this Article. Again, however, the argument is unpersuasive. To the extent that corporate law provisions are default norms, any information about the state of incorporation proves useless to those parties who cannot or will not consult the articles of incorporation before contracting with the corporation. It is only with regard to mandatory corporate law rules that the state of incorporation doctrine can be expected to increase transparency for third parties who are unaware of the content of a corporation's articles of incorporation. Admittedly, this finding does not, per se, eliminate the relevance of the transparency issue. As opposed to its U.S. counterpart,[163] European corporate law often relies heavily on mandatory norms in order to ensure the protection of third parties. For example, provisions on minimum capital requirements[164] or provisions on codetermination[165] fall into this category. As long as the state of incorporation doctrine is the only mechanism for exercising free choice in corporate law, one could argue, third parties can easily judge the applicability of such mandatory provisions by determining where the corporation is incorporated.

Nevertheless, the transparency argument suffers from a decisive flaw. A corporation's statutory seat will only be evident to third parties unable to consult the articles of incorporation if a corporation is, by law, required to disclose its state of incorporation. By the same measure, however, it is possible to force a corporation to disclose which law governs its internal affairs.[166]

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163. *Cf., e.g.*, Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990) [hereinafter Black, *Is Corporate Law Trivial?*] (noting that corporate law regimes in the U.S. primarily rely on enabling rather than mandatory norms).

164. For an overview—and critical assessment—of minimum capital requirements under European law, see Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165, 1174-1204 (2001).

165. Several Member States, including Germany, the Netherlands, Denmark, Luxembourg, and Sweden, have adopted statutes that govern codetermination for employees on supervisory and management boards. *See* Elmar Gerum & Helmut Wagner, *Economics of Labor Co-Determination in View of Corporate Governance*, in COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 341, 352 (Klaus J. Hopt et al. eds., 1998).

166. *Cf.* Romano, *Empowering Investors*, *supra* note 45, at 2362 (suggesting that corporations should be allowed to choose the applicable securities law and that they

To be sure, this reasoning still leaves those creditors unprotected, who cannot, for practical reasons, take into account the other party's organizational form.[167] But such "involuntary creditors" would be equally vulnerable if a corporation chose the applicable law by incorporating in another jurisdiction. Indeed, the only way to protect involuntary creditors is that suggested by Henry Hansmann and Reinier Kraakman—namely, to make sure that free choice does not extend to the rules governing the rights of involuntary creditors in the first place.[168]

B. *Slippery Slope*

One might also argue that the statutory approach to free choice threatens to lead down a slippery slope toward ever more federal rules in the field of corporate law.[169] Only by retaining the state of incorporation doctrine as the only mechanism for free choice, one could argue, can that danger be avoided. Yet whatever merits the slippery slope argument may or may not have in other contexts,[170] it does not hold with regard to the issue at hand. To begin with, there is little reason to believe that the statute suggested in this Article creates incentives or opportunities for further intervention. No federal agency is created that might seek to extend its influence by

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should be obliged to disclose their securities domicile at the time of initial public offerings).

167. It has long been recognized that certain types of contractual creditors have to be regarded as involuntary rather than voluntary creditors, precisely because they cannot, for various reasons, protect their own interests by demanding bargains that fully reflect the costs and benefits they incur in entering into the transaction. *See, e.g.*, Hansmann & Kraakman, *supra* note 162 (describing the "critical question" to be "whether the victim was able, prior to the injury, to assess the risks she took in dealing with the firm and to decline to deal if those risks seemed excessive in comparison with the net advantages she otherwise derived from the transaction").

168. *Cf. id.* at 1921-23 (arguing that "any state should be able to adopt unlimited shareholder liability for corporate torts ... for application to any tort claim to which the state's tort law applies, regardless of the state of incorporation of the corporate defendant").

169. Arguments of this type are by no means uncommon in the field of charter competition. For example, Bebchuck & Ferrell, *New Approach*, *supra* note 8, at 115, 143-61, recently suggested that the federal legislator adopt an optional federal takeover statute. Critics of this approach have objected that once a federal antitakeover statute is in place, even if it has a default character, there is an increased risk of federal intervention in the future. *See, e.g.*, Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 977 (2001) [hereinafter Choi & Guzman, *Choice and Federal Intervention*] (pointing out the risk that "a federal agency will eventually increase the scope of its laws and, perhaps, make them mandatory").

170. For a general assessment of the value of slippery-slope arguments, see Eric Lode, Comment, *Slippery Slope Arguments and Legal Reasoning*, 87 CAL. L. REV. 1469 (1999).

pushing for more intervention.[171] Also, nothing in this Article suggests that corporations should be able to incorporate directly under a federal statute, a move that might indeed prompt more aggressive federal intervention motivated by the desire to gain a lead in the market for corporate charters.[172] Of course, one could still argue that any federal intervention in the field of corporate law threatens to lead down a slippery slope, because existing political barriers to federal intervention are breached and hence destabilized. But that argument can at best apply if a political consensus against federal interventions exists, a consensus that would be undermined by the decision to adopt the statutory approach to free choice. Such a consensus, however, exists neither in the United States nor in Europe. In the European Community, there has long been a drive toward an ever-increasing harmonization of corporate law. Many areas—for example, the law governing mergers between domestic corporations[173] and minimal capital requirements[174]—have already been harmonized.[175] Others—such as the corporate law rules governing cross-border mergers—are likely to follow. The fear, therefore, that the statute might make future interventions more likely seems unfounded. Even in the United States there is no firm consensus against federal intervention in corporate law. Rather, the Sarbanes-Oxley Act of 2002[176] suggests that the federal legislator can invade the area of substantive corporate law with political impunity.[177]

C. *The Need for a Constitutional Basis*

In defense of retaining the state of incorporation doctrine as the only mechanism for exercising free choice in corporate law, one could

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171. *See, e.g.*, Choi & Guzman, *Choice and Federal Intervention*, *supra* note 169, at 977.

172. *See id.*

173. *See* Third Council Directive 78/855/EEC of 9 October 1978 based on Art. 54 (3) (g) of the Treaty concerning mergers of public limited companies, 1978 O.J. (L 295) 36.

174. Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by member states of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, 1977 O.J. (L 26) 1.

175. For an overview of existing Community rules in the area of company law, see VANESSA EDWARDS, EC COMPANY LAW 1-332 (1999).

176. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

177. *See also* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600-34 (2003) (noting a long history of federal intervention into state corporate law, beginning with the Securities Exchange Act of 1934).

also invoke the following pragmatic argument: both in the United States and in the Community, one could point out, the state of incorporation doctrine enjoys a certain amount of "constitutional" protection, being rooted, respectively, in the U.S. Constitution or in the TEC.

In both cases, one could plausibly conclude that the constitutional foundation of the state of incorporation doctrine is far from deeply entrenched. In the United States, the Supreme Court has never claimed outright that the state of incorporation doctrine is mandated by the U.S. Constitution.[178] Rather, the Court has only relied on the state of incorporation doctrine in its reasoning,[179] which may or may not indicate that it considers the doctrine to be rooted in the U.S. Constitution.[180] The Delaware Supreme Court has been more explicit, stressing that the application of the internal affairs doctrine is mandated by constitutional principles.[181] But it is far from clear whether that same conclusion would necessarily be reached by other courts.[182] The legal literature has questioned the constitutional foundation of the state of incorporation doctrine.[183] It should also be pointed out that Delaware's courts, in asserting the constitutional

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178. *See, e.g.*, Note, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy*, 115 HARV. L. REV. 1480, 1490-96 (2002) [hereinafter *The Internal Affairs Doctrine*].

179. In *Edgar v. MITE Corp.*, the U.S. Supreme Court addressed on the Illinois Business Take-Over Act, which limited the ability of foreign corporations to acquire corporations that had certain defined contacts with Illinois. 457 U.S 624, 645-46 (1981), The Court found a violation of the Commerce Clause, noting that "Illinois has no interest in regulating the internal affairs of foreign corporations." *Id.* In *CTS Corp. v. General Dynamics Corp. of America*, the Court relied on the internal affairs doctrine in an even more indirect fashion. 481 U.S. 69 (1987). "So long as each State regulates voting rights only in the corporations it has created," the Court pointed out, "each corporation will be subject to the law of only one State." *Id.* at 89.

180. *Cf.* Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CAL. L. REV. 29, 34-35 (1987) (noting that "the *CTS* Court comes dangerously close to embedding . . . the 'state of incorporation' version of the internal affairs doctrine—in the Constitution"); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 41 (arguing that *MITE* should not be read as constitutionalizing the *lex incorporationis*).

181. McDermott Inc. v. Lewis, 531 A.2d 206, 217 (Del. 1987); *see also id.* at 216 (claiming that the internal affairs doctrine is "of serious constitutional proportions—under due process, the commerce clause and the full faith and credit clause"); Draper v. Paul N. Gardner Defined Plan Trust, 625 A.2d 859, 866 (Del. 1993) (quoting *McDermott).*

182. It should be noted, in this context, that California's judiciary has not objected to the application of California law to the internal affairs of pseudo-foreign corporations. *See* Wilson v. Louisiana-Pacific Res., Inc., 138 Cal. App. 3d 216, 222-31 (Cal. Ct. App. 1982) (affirming the constitutionality of California's pseudo-foreign corporation statute).

183. *See, e.g.*, Buxbaum, *supra* note 180, at 35 (arguing that the "constitutional 'Delawarization' of state corporation law is not what *CTS* intends or effects"); *The Internal Affairs Doctrine, supra* note 178, at 1490-96 (arguing that the internal affairs rule is not, as a whole, constitutionally mandated).

nature of the state of incorporation doctrine, may not have been completely unbiased.[184] After all, Delaware is the state that profits most from the application of the internal affairs rule.[185] Similarly, the "constitutional" foundation of the state of incorporation in the Community is by no means written in stone. The Court's move toward the state of incorporation doctrine started only with the *Centros* decision in 1999.[186] Before that, the leading case on the real seat rule, the famous *Daily Mail* decision,[187] was understood by many to endorse the real seat rule.[188] Moreover, the reasoning underlying

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184. The claim that the Delaware judiciary is influenced by the desire to maximize Delaware's income from the charter market was famously raised by Cary in his philippic against Delaware law. *See* Cary, *supra* note 4, at 692 (suggesting that "Delaware may be characterized as a tight little club" and claiming that "participation in state politics and in the leading firms inevitably would align the Delaware judiciary solidly with Delaware legislative policy"). That reasoning is not altogether convincing. One cannot assume that Delaware judges will generally be willing to put the pecuniary interests of Delaware, let alone those of its corporate bar, above the interests of shareholders. This said, it does not seem unreasonable to suppose that Delaware's judges will be swayed by the interests of their state, when they believe the latter to be in line with the interests of shareholders. In fact, may well be the case in the context at hand. As Macey and Miller have pointed out, Delaware's judges are likely to "believe strongly in the efficacy of the Delaware legal system." *See* Jonathan R. Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporation Law*, 65 TEX. L. REV. 469, 502 (1987) [hereinafter Macey & Miller, *Toward an Interest-Group Theory*]. Accordingly, Delaware judges are also likely to believe that the foundation of Delaware's success in the charter market, the internal affairs rule, benefits shareholders.

185. *See, e.g., The Internal Affairs Doctrine*, *supra* note 178, at 1481.

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

187. Case C-81/87, Queen v. HM Treasury & Commissioners of Inland Revenue *ex parte* Daily Mail & General Trust plc, 1988 E.C.R. 5483, [1988] 3 C.M.L.R. 713 (1988).

188. *See, e.g.*, Peter Behrens, *Das Internationale Gesellschaftsrecht nach dem Centros-Urteil des EuGH*, 19 PRAXIS DES INTERNATIONALEN PRIVATRECHTS [IPRAX] 323, 322 (1999) (on file with author) (stating that *Daily Mail* suggested that the Court of Justice did not consider the real seat rule in violation of the Freedom of Establishment); Bernhard Großfeld, *Internationales Gesellschaftsrecht [Corporate Conflict of Laws]*, *in* J. VON STAUDINGERS KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH MIT EINFÜHRUNGSGESETZ UND NEBENGESETZEN ¶ 122 (Christian von Bar et al. eds., 1998) (on file with author) (citing the *Daily Mail* decision as evidence that the Court of Justice considered the real seat doctrine to be compatible with the Freedom of Establishment); Otto Sandrock, *Centros: Ein Etappensieg für die Überlagerungstheorie [Centros: A Stage Victory for the Theory of Superimposement]*, 54 BETRIEBSBERATER [BB] 1337, 1337 (1999) (on file with author) (claiming that the *Daily Mail* decision recognized the legality of the real seat rule); Clark D. Stith, Note, *Federalism and Company Law: A "Race to the Bottom" in the European Communities*, 79 GEO. L.J. 1581, 1603 (1991) (claiming that the Court addressed the issue of the real seat rule in deciding *Daily Mail*); *cf.* Ulrich Forsthoff, *Niederlassungsrecht für Kapitalgesellschaften nach dem Centros-Urteil des EuGH: Eine Bilanz [Freedom of Establishment for Corporations After the Centros-decision of the European Court of Justice: A Survey]*, EUROPARECHT [EUR] 167, 180 (2000) (pointing out that many voices in the literature unjustifiably advanced the *Daily Mail* decision as proof that the real seat doctrine was compatible with the Freedom of Establishment).

the *Centros* decision has met with sharp criticism in the legal literature.[189] In sum, neither the U.S. Constitution nor the TEC provides an unshakable foundation for the concept of free choice. Against this background, one could argue that securing free choice via statutory law bears a particular risk; from the perspective of the judiciary, such a statutory solution reduces the necessity of finding a constitutional basis for the state of incorporation doctrine. As a result, the chance of "constitutionalizing" free choice is missed. Should the federal legislator experience a change of mind later on, the state of incorporation doctrine will be far less entrenched than it could have been, had the legislator not adopted the statutory approach to free choice.

But there are obvious flaws in this argument. It goes without saying that a lack of trust in the efficiency of a particular legislative outcome is a somewhat questionable basis for judicial activism.[190] Even leaving aside democratic concerns, however, the above-described reasoning is unconvincing. To begin with, it should once again be recalled that this Article does not suggest eliminating the state of incorporation doctrine. Consequently, cases involving the state of incorporation doctrine will continue to face the courts, even if the statutory approach suggested in this Article is adopted. Moreover, even if the state of incorporation doctrine was retained as the sole mechanism for exercising free choice, it is by no means clear that its retention would enhance its constitutional protection. In the United States, the application of the state of incorporation doctrine does not, as a rule, make it necessary to invoke the Commerce Clause or any other provision of the U.S. Constitution. After all, courts have employed the state of incorporation doctrine long before the Supreme Court hinted, in *CTS Corp. v. General Dynamics*,[191] that it might be rooted in constitutional law.[192] At best, therefore, the above-described reasoning might apply to the European Community, where the state of incorporation doctrine has been imposed by declaring state law to be in violation of the Freedom of Establishment.[193] Even in the European context, however, it seems questionable whether

189. *Cf., e.g.*, KIENINGER, *supra* note 158, at 142-46 (summarizing the doctrinal critique directed against *Centros*).

190. *Cf.* Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 67 (1991) (pointing out that "an expansion of judicial review requires more than a demonstration that the political process often produces defective outcomes," because "we have no guarantee that judges empowered to review laws will only strike down . . . undesirable political outcomes; their review may also produce . . . undesirable political outcomes and strike down . . . desirable political outcomes").

191. 481 U.S. 69, 89 (1987).

192. *See, e.g.*, Wilkins v. Thorne, 60 Md. 253, 258 (Md. 1883) (applying the state of incorporation doctrine).

193. *See supra* text accompanying notes 14-17.

retaining the state of incorporation doctrine as the only mechanism for exercising free choice will truly contribute to the constitutionalization of free choice. In particular, it is far from clear whether, and to what extent, the European Court of Justice will continue to preclude the Member States from applying their own corporate law to pseudo-foreign corporations. After all, both in *Centros* and *Überseering*, the Court has indicated that the states may still be able to impose their own corporate law rules if such a course of conduct is necessary to protect stakeholders such as employees or third-party creditors.[194] Against this background, any attempt to reinforce the constitutional basis of the state of incorporation doctrine in Europe by relying on the Court of Justice to implement that doctrine may well backfire. The Court, anxious not to overstep the limits of legitimate judicial review,[195] may decide on a generous approach vis-à-vis the power of the Member States to apply their own corporate law. By contrast, creating a statutory foundation for free choice may well stabilize that concept. After all, such a move will increase legal certainty for corporations and hence prompt more European corporations to choose another Member State's corporate law. Once a significant number of corporations are governed by foreign law, however, any attempt by a Member State to reintroduce the real seat rule will burden the local economy with considerable transition costs. Hence, creating the statutory regime suggested in this Article may well be the approach most likely to guarantee the survival of free choice in the long run.

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194. *See* Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919, ¶ 92 ("It is not inconceivable that overriding requirements relating to the general interest, such as the protection of the interests of creditors, minority shareholders, employees and even the taxation authorities, may, in certain circumstances and subject to certain conditions, justify restrictions on freedom of establishment."); Case C-212/97, Centros Ltd. v Erhvervs-og Selskabstyrelsen, 1999 E.C.R. I-1459, ¶ 34, [1999] 2 C.M.L.R. 551, 586 (1999) (noting that national measures restricting the fundamental freedoms are compatible with the Treaty if they are applied in a non-discriminatory manner, justified by imperative requirements in the general interest, suitable for securing the attainment of the objective that they pursue, and if they do not go beyond what is necessary in order to attain it); *cf.* Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 24 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 1885, ¶ 133 (2003) (noting that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must, if they are to be justified, fulfill four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the public interest; they must be suitable for securing the attainment of the objective that they pursue; and they must not go beyond what is necessary in order to attain it).

195 It should be noted, in this context, that the European Community has long been under fire for allegedly suffering from a "democracy deficit." *Cf., e.g.*, J. H. H. Weiler, *The Transformation of Europe*, 100 YALE L.J. 2403, 2466-74 (1991) (summarizing concerns that the actions of the Community's organs such as the Council and the Commission are not subject to sufficient democratic control).

VI. WHY DID WE END UP WITH THE STATE OF INCORPORATION DOCTRINE AS THE ONLY MECHANISM FOR EXERCISING FREE CHOICE IN CORPORATE LAW?

A central problem remains. If it is truly efficient to grant corporations the freedom to choose the applicable law in their articles of incorporation, why has such a rule not yet been adopted? In answering that question, one must distinguish between lawmakers and courts.

A. *Why Have Lawmakers Failed to Adopt the Approach Discussed in this Article?*

It is fairly easy to see why legislators have not adopted the statutory approach to free choice suggested in this Article. In a nutshell, lawmakers at both the federal and the state level will not generally be thrilled at the idea of free choice in the first place. Hence, it is unlikely that they will search for ways to increase corporate mobility.

First, consider the incentives that state legislators face. In any federal system adhering to the concept of free choice, there is a certain probability that corporations will concentrate on one or a few jurisdictions. After all, some jurisdictions will usually offer more attractive substantive rules and a better court system than others. Moreover, once a jurisdiction is the legal home to a disproportionate number of corporations, that jurisdiction will also profit from positive network externalities[196] including, in particular, a large body of precedent[197] and judges experienced in the application of corporate law norms.[198] If corporations concentrate on one or a few states, however, most jurisdictions will end up losing corporate charters. Correspondingly, the lawmakers of those states are bound to lose some of their influence. They can hardly be expected, therefore, to call for an increase in corporate mobility. That does not mean, of course, that they will necessarily call for restrictions to free choice. Especially in those cases where free choice has already been established by courts, lawmakers may be unwilling to incur the wrath of local enterprises by putting an end to that system. But they hardly have an incentive to call for more of the same either. Moreover, even

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196. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 842-47 (1995) (describing network benefits enjoyed by corporations incorporated in popular states of incorporation).

197. *Id.* (categorizing such benefits as "interpretative network externalities").

198. *Id.* To be sure, the fact that the expertise of Delaware's judges can be attributed to specialization has been known long before the concept of network effects was explicitly introduced into the debate on charter competition. *See, e.g.*, Black, *Is Corporate Law Trivial?*, *supra* note 163, at 589-90.

states such as Delaware that attract a disproportionate number of corporate charters are unlikely to call for a federal rule of the type suggested in this Article. After all, under such a statutory approach to free choice, the ability of the relevant states to collect franchise taxes can only be secured by federal intervention; federal law must ensure that corporations pay franchise taxes to those states whose law is declared applicable in the articles of incorporation. Whether such a rule would be the outcome of the federal legislative process, however, is hardly foreseeable. Hence, states profiting from the charter market will rationally decide not to risk the goose that lays golden eggs by calling for a statutory approach to free choice.

At first glance, the federal legislator might be more interested in furthering free choice. After all, as long as corporations do not incorporate at the federal level, the federal legislator does not need to fear losing corporate charters to competing jurisdictions. Yet there are other factors that may prevent the federal legislator from adopting the approach suggested in this Article. Regarding the European Community, it should be noted that legislation can only be enacted if it is adopted by the Council, [199] where the Member States are represented.[200] Given that most Member States have little incentive to adopt free choice, the Council—and hence, the Community legislator—is unlikely to see matters differently. In the United States, the federal legislative process may seem more conducive to the enactment of legislation promoting free choice. But even there, the federal legislator has little reason to adopt a federal rule that is bound to meet with opposition from practically every state government.

The above-described theoretical considerations are, at least to some degree, confirmed by practical experience. To the extent that U.S. and European lawmakers have interfered with the rules governing the corporate conflict of laws, it has usually been to restrict, rather than promote, free choice. This is particularly true in the European Community. The real seat doctrine, which has traditionally prevailed among European jurisdictions,[201] was often introduced, or at least codified, by legislation.[202] By contrast, those

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199. *See, e.g.*, T.E.C., *supra* note 10, at art. 44(1) ("In order to attain Freedom of Establishment as regards a particular activity, the Council, acting in accordance with the procedure referred to in Article 251 and after consulting the Economic and Social Committee, shall act by means of directives.").

200. *Id.* at art. 203(1) ("The Council shall consist of a representative of each Member State at ministerial level, authorized to commit the government of that Member State.").

201. *See* sources cited *supra* note 11.

202. For example, that has been the case in Belgium, where the legislator imposed the real seat doctrine in 1873 in order to prevent corporations from evading Belgian law. *See* Großfeld, *Anerkennungstheorien*, *supra* note 23, at 211-12. In Austria, too, the real seat doctrine is explicitly set forth by statute. *See* § 10

few Member States that adhere to the state of incorporation doctrine typically owe that doctrine to the judiciary rather than to statutory law.[203] Even the Community legislator has shown his sympathy for the real seat doctrine. The recently adopted regulation of the so-called European Company,[204] an organizational form governed in part by Community law and in part by state law, explicitly embraces the real seat rule; Article 7 of the this regulation demands that the registered office of a European Company, which determines the applicable state law, must be in the same state as the real seat.[205] A similar approach was taken by the Community legislator with regard to another organizational form—namely, the so-called European Economic Interest Grouping (EEIG)—which was created by regulation in 1985.[206] According to Article 2(1) of the regulation at issue, the law applicable to the internal organization of an EEIG shall

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Bundesgesetz über das internationale Privatrecht, v. 15.6.1978 (BGBl. I S.304). Italian statutory law, too, explicitly provides that corporations having their real seat in Italy are governed by Italian corporate law. *See* Art. 25 Legge 31 maggio 1995, no. 218, Riforma del sistema italiano di diritto internazionale private, Supplemento ordinario alla Gazzetta Ufficiale del 3 giugnio 1995. Similarly, Spanish statutory law explicitly provides that the statutory seat of corporations that have their principal place of business in Spain must be in Spain. *See* Art. 5(1) Ley de Sociedades Anónimas (R.C.L. 1989, 1564). The same is true in France. *See* art. 3(1) Loi No. 66-537 of July 24, 1966, J.O., July 26, 1966, p. 6402; 1966 D.S.L. 265 ("Les sociétés dont le siège social est situé en territoire français sont soumises à la loi française.").

203. As regards the United Kingdom, *see* Großfeld, *Anerkennungsproblematik*, *supra* note 22, at 345 (analyzing the judgment that first introduced the state of incorporation doctrine in the United Kingdom.). The same is true in Austria, where the courts—spurned by the *Centros* decision—have only recently chosen to partially abandon the real seat doctrine in favor of the state of incorporation doctrine. *See* OGH, 55 JURISTENZEITUNG [JZ] 199, 199 (2000); OGH, 11 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [EuZW] 156, 156 (2000). For a critical comment on these decisions, see Werner F. Ebke, *Centros—Some Realities and Some Mysteries*, 48 AM. J. COMP. L. 623, 656-57 (2000) (arguing that the Austrian Supreme Court misunderstood the European Court of Justice's holding in *Centros*). As regards Denmark, there seems to have been some uncertainty as to whether the real seat rule or the state of incorporation doctrine applied. *See* KIENINGER, *supra* note 158, at 119 n.95 (summarizing contradictory statements by various authors). In the end, the decision seems to have been made by the judiciary in 1998. *See* Paul Krüger Andersen & Engsig Sorensen, *Free Movement of Companies from a Nordic Perspective*, 6 MAASTRICHT J. EUR. & COMP. L. [MJ] 47, 56 (1999). An exception to this rule are the Netherlands, where the state of incorporation doctrine is explicitly endorsed by statutory law. *See* Wet conflictenrecht corporaties, art. 2 (1997) (on file with author). At the time the Act was adopted, however, the struggle between the real seat doctrine and the state of incorporation doctrine had long been decided in favor of the latter. *See* KIENINGER, *supra* note 158, at 180. Hence, the Dutch legislator was only codifying the status quo.

204. Council Regulation 2157/2001 on the Statute for a European Company, 2001 O.J. (L 294) 1 [hereinafter SE-Regulation].

205. *Cf.* SE-Regulation, *supra* note 204, art. 7(1) ("The registered office of an SE shall be located within the Community, in the same Member State as its head office.").

206. *See* Council Regulation 2137/85 on the European Economic Interest Grouping, 1985 O.J. (L 199) 1-4.

be the law of the state in which the official address is situated.[207] At the same time, however, Article 12(2) provides that "[t]he official address must be fixed either: (a) where the grouping has its central administration, or (b) where one of the members of the grouping has its central administration or, in the case of a natural person, his principal activity, provided that the grouping carries on an activity there."[208]

In the United States, the situation is more ambiguous. After all, the Revised Model Business Corporation Act explicitly codifies the state of incorporation doctrine,[209] and many states have followed its lead.[210] It should be noted, however, that the rule in question did not change the law when it was first suggested. Rather, it reflected the then-existing status quo.[211] By contrast, in those cases where state lawmakers modified the status quo, it was to restrict free choice, either by means of pseudo-corporation statutes,[212] or—in the case of the federal legislator—by federalizing corporate law.[213] In sum, both theoretical considerations and past experience suggest that lawmakers are unlikely to actively promote free choice. It follows that lawmakers generally cannot be expected to take measures facilitating free choice, even if such measures promise efficiency gains.

B. *Why Have Courts Failed to Adopt the Approach Discussed in this Article?*

The question remains, of course, why the courts that adopted the state of incorporation doctrine did not also grant corporations the freedom to choose the applicable law in their articles of incorporation.

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207. *Id.* art. 2(1).

208. *Id.* art. 12.

209. *Cf.* MODEL BUS. CORP. ACT § 15.05(c) (1984) ("This Act does not authorize this state to regulate the organizations or internal affairs of a foreign corporation authorized to transact business in this state.").

210. *See, e.g.*, ALA. CODE § 10-2B-15.05(C) (2003); ALASKA STAT. § 10.20.455 (3) (2003); ARIZ. REV. STAT.§§ 10-1505(C),10-11505(C) (2003); ARK.CODE ANN. § 4-27-1505(C) (2003); COLO. REV. STAT. § 7-115-105 (2003); CONN. GEN. STAT. § 33-924(C) (2003); FLA. STAT. ch. 607.1505(3) (2003); GA. CODE ANN. § 14-2-1505 (2003); HAW. REV. STAT. § 414-435 (C) (2003); TEX. BUS. CORP. ACT ANN. art. 8.02 (2003).

211. U.S. courts had embraced the state of incorporation doctrine far earlier. *See, e.g.*, Wilkins v. Thorne, 60 Md. 253, 258 (Md. 1883) (embracing the state of incorporation doctrine with regard to a pseudo-foreign corporation). An analysis of the historical origin of the internal affairs doctrine is undertaken by Richard M. Buxbaum, *The Origins of the American "Internal Affairs" Rule in the Corporate Conflict of Laws*, in FESTSCHRIFT FÜR GERHARD KEGEL ZUM 75. GEBURTSTAG (H.-J. Musielak & K. Schurig eds., 1987).

212. *See* CAL. CORP. CODE § 2115 (West 1993 & Supp. 2002); N.Y. BUS. CORP. LAW § 1320 (McKinney's 1986 & Supp. 2002).

213. *See generally* Roe, *supra* note 177 (providing an overview of federal incursions in the area of corporate law).

1. The European Community

With regard to the European Community, that question is relatively easy to answer. At least two factors explain why the European Court of Justice has failed to grant corporations the right to choose the applicable law in their articles of incorporation. Most important, there are doctrinal reasons to consider. The wording of the TEC makes it relatively easy to find the real seat doctrine in violation of the Freedom of Establishment, but it does not give the slightest hint that corporations might be entitled to choose the applicable law in their articles of incorporation. Consider, first, the case for banning the real seat doctrine: TEC Article 43(1)(1) gives European citizens the right to establish themselves in the territory of other Member States.[214] TEC Article 48 extends this right to corporations by providing that "[c]ompanies . . . formed in accordance with the law of a Member State . . . [must] be treated in the same way as natural persons who are nationals of Member States."[215] Obviously, the real seat doctrine can have harsh consequences for a corporation formed under the law of one Member State, but whose real seat is established in another. For example, if a U.K. company moves its headquarters to Germany without reincorporating under German law, German courts, assuming that they apply the real seat doctrine, will treat the organization as a partnership, subjecting all its shareholders to unlimited liability.[216] Against this background, the idea that the real seat doctrine constitutes an obstacle to the Freedom of Establishment is not particularly difficult to reach from the text of the TEC,[217] as even critics of the *Centros* decision admit.[218] Indeed, even before *Centros*, European scholars had long been discussing the question of whether the real seat rule is compatible with the law of the European Community.[219] Consequently, the main

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214. *Cf.* T.E.C., *supra* note 10, art. 43(1)(1) ("Within the framework of the prohibitions set out below, restrictions on the Freedom of Establishment of nationals of one Member State in the territory of another Member State shall be prohibited.").

215. *Id.* art. 48.

216. *See, e.g.*, Ebenroth & Sura, *supra* note 138, at 317; Fischer, *supra* note 138, at 101.

217. Both in *Centros* and in *Überseering*, the Court's reasoning relied strongly on the wording of the Treaty. *See, e.g.*, Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919, ¶¶ 56, 75; Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabstyrelsen, 1999 E.C.R. I-1459, ¶ 19, [1999] 2 C.M.L.R. 551, 584 (1999)

218. *See, e.g.*, KIENINGER, *supra* note 158, at 143-44.

219. *See, e.g.*, DOMINIK SCHNICHELS, REICHWEITE DER NIEDERLASSUNGSFREIHEIT [THE SCOPE OF APPLICATION OF THE FREEDOM OF ESTABLISHMENT] 155-99 (1995) (on file with author) (arguing that the real seat doctrine violates the Freedom of Establishment); Rainer Deville, *Anmerkung zum Beschluß des Bayerischen Obersten Landesgerichts vom 18.7.1985—BReg. 3Z 62/85* [*A Comment on the Decision of the Bavarian Supreme Court from July 18, 1985—BReg. 3Z 62/85*], 32

criticism directed against the *Centros* doctrine is not textualist but, rather, purposivist in nature: the Freedom of Establishment, some scholars claim, is intended to allow enterprises to operate a business in another state. [220] By contrast, they argue, its purpose is not to allow firms to choose the most attractive corporate law regime.[221] But the latter alleged purpose is not really reflected in the text of the TEC. Hence, it was not difficult for the Court of Justice to decide in favor of the application of the Freedom of Establishment.

By contrast, it would be extremely challenging from a doctrinal perspective to reason that a Member State violates the Freedom of Establishment by refusing domestic corporations the right to choose another Member State's corporate law in their articles of incorporation. As mentioned before, TEC Article 43(1)(1) gives European citizens the right to establish themselves in the territory of other Member States.[222] Opting for another Member State's corporate law without setting up a business in that state or incorporating there, however, can hardly be categorized as establishing oneself in that state. Moreover, the Court has long adhered to the principle that the fundamental freedoms do not apply to purely internal situations, in which a state burdens its own citizens.[223] Yet it is precisely such an internal situation that arises

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RECHT DER INTERNATIONALEN WIRTSCHAFT [RIW] 298, 298 (1986) (arguing that the real seat doctrine does not violate the Freedom of Establishment); Carsten Thomas Ebenroth, *Neuere Entwicklungen im deutschen internationalen Gesellschaftsrecht [Recent Developments Regarding the German Rules Governing Conflicts of Laws in the Field of Corporate Law]*, 43 JURISTENZEITUNG 18, 24 (1988) (on file with author) (suggesting that the real seat doctrine does not violate T.E.C. Art. 43); Bernhard Großfeld, *Die "ausländische juristische Person & Co. KG" [The Limited Partnership with a Foreign Corporation as General Partner]*, 6 PRAXIS DES INTERNATIONALEN PRIVATRECHTS [IPRAX] 145, 145 (1986) (on file with author) (arguing that the real seat doctrine does not violate Art. 43 of the TEC).

220. *See, e.g.*, KIENINGER, *supra* note 158, at 145-46; Hans-Georg Koppensteiner, *Centros und die Folgen [Centros and the Consequences]*, *in* GESELLSCHAFTSRECHT IN DER DISKUSSION 1999 151, 163 (Gesellschaftsrechtliche Vereinigung ed., 2000) (on file with author); Daniel Zimmer, *"Mysterium Zentros." Von der schwierigen Suche nach der Bedeutung eines Urteiles des Europäischen Gerichtshofes ["Mystery Centros." Of the Difficult Search for the Meaning of a Judgment by the European Court of Justice]*, 164 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT [ZHR] 23, 40 (2000) (on file with author).

221. *See* sources cited *supra* note 220.

222. *Cf.* T.E.C., *supra* note 10, art. 43 ("Within the framework of the prohibitions set out below, restrictions on the Freedom of Establishment of nationals of one Member State in the territory of another Member State shall be prohibited.").

223. *See, e.g.*, Case 204/87, Criminal Proceedings against Guy Bekaert, 1988 E.C.R. 2029, ¶ 13, [1988] 2 C.M.L.R. 655, 660 (1988); Case 20/87, Ministère public v. André Gauchard, 1987 E.C.R. 4879, ¶ 13, [1989] 2 C.M.L.R. 489, 500-01 (1989); Case 298/84, Paolo Iorio v. Azienda autonoma delle ferrovie dello Stato, 1986 E.C.R. 247, ¶ 17, [1986] 3 C.M.L.R. 665, 671 (1986). In the literature see, for example, Walter Frenz & Inés Grande, *Versteckte Diskriminierungen am Schnittpunkt von Niederlassungs- und Dienstleistungsfreiheit [Hidden Discrimination at the Dividing*

when a Member State denies its own corporations the freedom to freely choose the corporate law norms that govern their internal affairs. In sum, it would be extremely difficult to justify why the Freedom of Establishment should give corporations the right to choose the applicable state law in their articles of incorporation.

Apart from these doctrinal considerations, a second factor should not go unmentioned. *Centros*, *Überseering*, and *Inspire Art* have ushered in the state of incorporation doctrine by making it clear that the real seat rule, in its current form, is not compatible with the Freedom of Establishment.[224] That does not mean, however, that the Court actually intended to pave the way for free choice in corporate law. Rather, there is some circumstantial evidence that the Court simply hoped to prod the Member States toward further harmonization. In particular, two factors deserve attention. First, one should note the political environment in which the *Centros* decision was handed down. At the time, harmonization in the field of corporate law had reached an impasse; Europeans had been trying for decades to create a European company statute.[225] But before *Centros*, these attempts had gone nowhere. The central issue dividing the Member States was the participation of employees in the company's management.[226] Not surprisingly, Germany did not want to abandon its codetermination laws, while other Member States—particularly the United Kingdom—were unwilling to accept mandatory rules on codetermination.[227]

From the outset, *Centros* had the potential to break this deadlock. That can be explained as follows: the German rules on codetermination are worded in such a way that they only apply to corporations formed under German law.[228] If Germany recognizes

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Line Between the Freedom of Establishment and the Freedom to Provide Services], 13 EUROPÄISCHES WIRTSCHAFTS- UND STEUERRECHT [EWS] 555, 557 (2002) (on file with author).

224. *See supra* text accompanying notes 14-17.

225. *See, e.g.*, Christian Kersting, *Corporate Choice of Law—A Comparison of the United States and European Systems and a Proposal for a European Directive*, 28 BROOK. J. INT'L. L. 1, 54 (2002).

226. *Id.* at 55.

227. *Cf.* Mike Smith, *Agreement will ease corporate operations across EU. European Company Statute 30-Year Block Lifted After Pact on Worker Representation*, FIN. TIMES (LONDON), Dec. 9, 2000, at 5 (noting that "[t]he 30-year block on a company statute resulted from the different traditions on worker involvement, from Germany, where participation is strong, to countries such as Spain and the United Kingdom, where it is more limited").

228. The various German statutes on codetermination explicitly list the organizational forms to which they are applicable, and they only name certain German organizational forms such as the Aktiengesellschaft (stock corporation) or the Gesellschaft mit beschränkter Haftung (Limited Liability Company). *See* Gesetz über die Mitbestimmung von Arbeitnehmern (MitbestG), v. 4.5.1976 (BGBl. I S.1153); Gesetz zur Ergänzung des Gesetzes über die Mitbestimmung der Arbeitnehmer in den Aufsichtsraten und Vorständen der Unternehmen des Bergbaus und der Eisen und

pseudo-foreign corporations—as demanded by *Centros*—the relevant rules can be circumvented relatively easily, at least by newly formed businesses. At the same time, *Centros* has not made it entirely clear whether it would be legal to modify the German rules in such a way as to ensure their application to pseudo-foreign corporations. After all, the Member States retain the right, under *Centros*, to impose restrictions on foreign corporations, provided that these restrictions are a necessary and proportionate means to achieve imperative requirements in the public interest.[229] Consequently, one can reasonably argue that the *Centros* decision does not stand in the way of a legislative amendment to the German rules on codetermination that would extend their scope of application to pseudo-foreign corporations.[230] Against this background, it is not hard to see why *Centros* was bound to increase the Member States' willingness to reach a compromise; from Germany's perspective, *Centros* could be read as a warning that the Court would no longer tolerate inactivity in the field of corporate law harmonization and that the Freedom of

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Stahl erzeugenden Industrie (MitBestErgG), v. 7.8.1956 (BGBl. I S.707); Betriebsverfassungsgesetz 1952 (BetrVG), Oct. 1952 (BGBl. I S.681); Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsraten und Vorstanden der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie (Montan-MitbestG), v. 21.5.1951 (BGBl. I S.347). Moreover, under the prevailing view, the relevant statutes cannot be applied to foreign corporations by analogy. *See, e.g.*, THOMAS RAISER, MITBESTIMMUNGSGESETZ [CODETERMINATION ACT] § 1, ¶ 10 (4th ed. 2002); Peter Ulmer, *Schutzinstrumente gegen die Gefahren aus der Gewerbstätigkeit inländischer Zweigniederlassungen von Kapitalgesellschaften mit fiktivem Auslandssitz [Protective Mechanisms Against the Risks Resulting from the Activities of Domestic Branch Offices of Pseudo-Foreign Corporations]*, 54 JURISTENZEITUNG [JZ] 662, 663 (1999) (on file with author).

229. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459, ¶ 34, [1999] 2 C.M.L.R. 551, 586 (1999). The Attorney General La Pergola, who wrote the corresponding opinion, also pointed to the option of harmonization: "[I]n the absence of harmonisation, competition among rules must be allowed free play in corporate matters." *See* Opinion of Mr Advocate General La Pergola, Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabbsstyrelsen, 1999 E.C.R. I-1459, ¶ 20, [1999] 2 C.M.L.R. 551, 576 (1999).

230. *See* Jens C. Dammann, *The Future of Codetermination after* Centros: *Will German Law Move Closer to the U.S. Model?*, 8 FORDHAM J. CORP. & FIN. L. 607, 685 (2003). Indeed, this view now seems to have gained ground in the legal literature. *See, e.g*, Roth, *supra* note 162, at 199 (claiming that workers' codetermination is "at first sight, a convincing candidate for a 'general interest'-justification"). *But see* Horst Hammen, *Zweigniederlasssungsfreiheit europäischer Gesellschaften und Mitbestimmung der Arbeitnehmer auf Unternehmensebene [Branch Offices of European Corporations and Codetermination on the Level of the Enterprise]*, 45 WERTPAPIER-MITTEILUNGEN [WM] 2487, 2495 (1999) (on file with author) (arguing that Germany cannot extend the scope of its codetermination rules to cover pseudo-foreign corporations); Daniel Zimmer, *Internationales Gesellschaftsrecht und Niederlassungsfreiheit: Das Rätsel vor der Lösung? [Rules Governing Conflicts of Laws in Corporate Matters and the Freedom of Establishment: A Riddle About to be Solved?]*, 55 BETRIEBS-BERATER [BB] 1361, 1365-66 (2000) (on file with author) (doubting whether the German system of codetermination is justified by an imperative requirement in the sense of the European Community law).

Establishment might be used as a means of allowing corporations to avoid completely the German rules on codetermination. At the same time, the Member States opposed to codetermination could not be certain that they would succeed by holding out. After all, it did not seem—and still does not seem—impossible that the Court will consider the application of Germany's codetermination rules to be justified by mandatory requirements. In sum, both adherents and opponents of codetermination had every reason to reach a compromise.

It should be noted, furthermore, that if it was the wish of the Court to promote the harmonization of European corporate law, that strategy has already borne fruit. In 2001, little more than two years after the *Centros* decision, the Member States reached a compromise regarding the so-called European Company,[231] including the issue of codetermination.[232]

The impression that *Centros* was not an attempt at ushering in an era of free choice, but was instead intended to promote further harmonization, is reinforced by the decision's wording. In part, the judgment almost reads as an invitation to eliminate the opportunity for state competition it creates. As the Court states:

> [T]he fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive . . . cannot, in itself, constitute an abuse of the right of establishment. . . . [I]t is always open to the Council, on the basis of the powers conferred upon it by Article 54(3)(g) of the EC Treaty, to achieve complete harmonization.[233]

In sum, there are no less than two explanations as to why the European Court of Justice has failed to grant corporations the right to choose the applicable state law in their articles of incorporation. First, such a course of action would have been next to impossible to justify from a doctrinal perspective. Second, the Court may never have intended to set the stage for free choice in corporate law in the first place.

2. The United States

Why have U.S. courts never recognized the right of corporations to choose the applicable corporate law in their articles of incorporation? At first glance, it seems that they could have done so much more easily than the European Court of Justice. After all,

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231. *See* Council Regulation 2157/2001 on the Statute for a European Company, 2001 O.J. (L 294) 1.

232. *See* Council Directive 2001/86/EC supplementing the Statute for a European Company with regard to the involvement of employees, 2001 O.J. (L 294) 22.

233. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459, ¶¶ 27-28, [1999] 2 C. M.L.R. 551 (1999).

given that U.S. corporations traditionally enjoy free choice in corporate law, it would have been a comparatively small step to recognize also their right to exercise free choice via a choice-of-law provision in their articles of incorporation. But even in the United States, doctrinal obstacles unrelated to efficiency considerations may have prevented courts from adopting such an approach.

Early U.S. jurisprudence tended to view the corporation as a mere legal fiction. In the words of Chief Justice Marshall, the corporation was seen as an "invisible, intangible, and artificial being, [a] mere legal entity."[234] This reasoning, of course, has obvious implications for the issue at hand. If a corporation is but the creation of the law of the jurisdiction in which it was formed, then it follows that the corporation's internal affairs must be governed by that law alone. As Marshall stated in a later opinion, "[b]eing the mere creature of law, [the corporation] possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."[235] That line of reasoning proved to be highly influential.[236] State courts relied on it to explain why corporations cannot go beyond the rules imposed by the state of incorporation. Thus, it has been stressed that "[a] corporation is a purely artificial body created by law. It can act only in accordance with the law of its creation."[237]

To be sure, the view of the corporation as a legal fiction is unlikely to have played a decisive role in more recent times. Nevertheless, the basic problem remains: each corporate law regime defines the preconditions for the formation of a corporation and the rules governing the affairs of such corporations. How, then, can a court allow corporations to deviate from these conditions by referring to another state's law, without disobeying the legislature? The difficulty of answering that question in a satisfactory manner is reinforced by the state statutes governing corporate law. Corporate codes tend to specify the types of provisions that the articles of incorporation may contain,[238] typically requiring that the provisions contained therein must not be contrary to the laws of the state of incorporation.[239] That limitation, of course, only makes sense if one

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234. Bank of United States v. Deveaux, 9 U.S. 61, 86 (1809).

235. Tr. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636 (1819).

236. *Cf., e.g.*, CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987). There, the Court relied on Marshall's view of the corporation as an artificial being to justify the interest of the state of incorporation in regulating the internal affairs of its own corporations.

237. *See In re* Brophy, 179 A. 128, 129 (N.J. 1935) (*quoting In re Amer. Fibre*); *In re* Am. Fibre Chair Seat Corp., 193 N.E. 253, 255 (N.Y. 1934); *In re* Crown Heights Hosp., Inc., 49 N.Y.S.2d 658, 660 (N.Y. Sup. Ct. 1944).

238. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102 (2003).

239. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(1) (2003).

assumes that corporations cannot, in their articles of incorporation, declare the law of the state of incorporation to be inapplicable.

All in all, even if one shares the view advanced in this Article—namely, that it would be efficient to grant corporations the right to choose the applicable state law in their articles of incorporation—it is evident why courts and legislators in the United States and in Europe have so far failed to adopt such an approach.

VII. CONCLUSION

Free choice in corporate law is no longer a concept confined to the United States or Canada. Rather, three recent decisions by the Court of Justice, *Centros*, *Überseering*, and *Inspire Art*, have ushered in the age of charter competition in the European Community. Very likely, they also herald the coming of an era marked by transatlantic charter competition.

Against this background, it is high time to focus not only on the general desirability of free choice in corporate law, but also on the question of how free choice should best be granted, be it in the U.S., the European, or the transatlantic arena. Traditionally, the only mechanism by which corporations can exercise free choice has been the state of incorporation doctrine, under which a corporation's internal affairs are governed by the law of the state of incorporation. It is important to note, however, that the state of incorporation doctrine has a number of significant drawbacks because it does not allow corporations to choose a foreign state's corporate law in isolation. Rather, it forces them to accept a number of side effects that may discourage them from incorporating in the jurisdiction with the law they find most efficient. These side effects include exposure to litigation in the state of incorporation. As far as the transatlantic charter market is concerned, pseudo-foreign corporations may in addition face a higher income tax burden. Finally, European corporations incorporating in the United States risk the application of U.S. securities law.

> In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: (1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the members of a nonstock corporation; if such provisions are not contrary to the laws of this State.

DEL. CODE ANN. tit. 8, § 102(b)(1); MODEL BUS. CORP. ACT § 2.02(b) (1984) ("The articles of incorporation may set forth . . . provisions not inconsistent with law regarding. . . .").

That the state of incorporation doctrine is, in many respects, deficient as a mechanism for exercising free choice in corporate law cannot come as a surprise. The state of incorporation doctrine does not owe its exclusivity to efficiency considerations. Rather, the explanation for the primacy of the state of incorporation doctrine is as follows: lawmakers are typically hostile to free choice because they do not wish to relinquish their influence over locally operated corporations. Hence, free choice had to be granted by the courts. For the judiciary, however, the state of incorporation doctrine offers an easy way to justify the application of the legal regime that a corporation has chosen.

Against this background, it is desirable that the state of incorporation doctrine be complemented with what has been called in this Article a statutory approach to free choice. Federal law should allow corporations to choose the applicable state law in their articles of incorporation. Corporations could thus determine freely which corporate law regime should govern their internal affairs. The law of the state of incorporation should only be the default that governs if the articles do not contain any choice-of-law clause. To preserve the states' incentive to compete, federal law could require the state of incorporation to force its corporations to pay franchise fees to those states whose law is declared applicable. The amount to be paid could be determined freely by the recipient state.

The relevance of the statutory approach to free choice has been shown with regard to the transatlantic charter market. Currently, such a charter market does not exist. One could attempt to explain this by pointing to certain factors that are unrelated to the shortcomings of the state of incorporation doctrine. The traditional prevalence of the real seat doctrine in Europe, rules that prevent corporations from migrating between U.S. and European jurisdictions, or a lack of demand for U.S. corporate law might be cited in this context. But all of these factors are insufficient to explain the general unwillingness of European firms to incorporate in jurisdictions on the other side of the Atlantic. Hence, one has to conclude that the drawbacks of the state of incorporation doctrine play a decisive role in preventing the emergence of a transatlantic charter market.