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The Delaware Effect

A Comparison between *Institutional Competition* and
Harmonisation in the Field of Corporate Law

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Summary

TITLE	The Delaware Effect - A Comparison Between <i>Institutional Competition</i> and <i>Harmonisation</i> in the Field of Corporate Law
AUTHOR	Sebastian Bonnevier-Dudzik
TUTOR	Professor Ingemar Ståhl
PURPOSE	The purpose of this thesis is to apply an economist's view, of the corporate law in general and on the corporation in particular, in order to schematically study the feature of Institutional Competition from a Swedish perspective.
METHOD	I will in this thesis use the method known as Law and Economics. The basic principle of this theoretical approach is an application of economic principles to legal institutions, instruments, questions and procedures.
CONCLUSION	Corporations find themselves the corporate law "smorgasbord" in the US while the European corporate law market is getting increasingly unyielding. For several reasons I believe the fear of the "Delaware Effect" to be exaggerated: 1, since several event studies show the opposite, 2, given that the most popular state of incorporation has a relatively strong corporate law, and 3, since the weak member states' incentives make intense Institutional Competition unlikely. However, "excellence centres", showing as good examples, will be copied, thus creating a positive competition. In that perspective the European harmonisation process might be a hindrance to the corporate law evolution.
KEY WORDS	Corporate Governance, Corporate Law, Harmonisation, Institutional Competition, Law and Economics, Transaction Costs

Preface

The writing of this thesis has been a strenuous but very interesting journey. I have found the work very stimulating but also frustrating, as I meanwhile have worked as CEO assistant to Lars Holmqvist at WeSpot AB and also been one of the founders of a e-learning company, LearningZone AB. Professor Ingemar Ståhl has been as well patient and understanding as keen on tutoring; I owe him gratitude for his support. I also would like to thank Marcus Glader at the Faculty of Law in Lund for helpful discussions regarding my thesis, and Anette Bruzelius at the Faculty of Law in Lund and Hanne Søndergaard Birkmose at Handelshøjskolen in Århus for their friendly support with material. Eventually, I would like to thank Carolina Bornudd and Linda Gustafsson for their support when it comes to correcting my worse language errors.

Lund, summer of 2001,

Sebastian Bonnevier-Dudzik

1 Introduction

1.1 Why is there Law?

1.1.1 In the Beginning there was Contract

The corporation is historically a young institution that has rapidly won great success, much due to that it creates an institutional frame to efficiently disperse risk, which drastically lowers cost of capital. However, the separation of ownership and control gives rise to conflicts of interests that can be categorised as the corporation's three main issues: the conflict between shareholders v. management, majority v. minority and shareholders v. lenders.¹ These, so called agency problems, are dealt with in the field of corporate governance.

The prerequisites of the corporation can always be governed by regulation, but an alternative way should let the parties decide for themselves via contract or have a mixture of laws and supplementary contracts. The concern of Law & Economics theorists is to strike a balance between contract and regulation in order to deal with the above-mentioned three main issues.

Naturally, a single contract would not suffice to exhaustively deal with every aspect of business, why a common metaphor is the "Nexus of Contracts"(see 2 below). Even if one would perfectly contract on every issue at the time the corporation is founded, subsequent contracts will change the "risk position" in a way that cannot be foreseen. (For instance, what will happen to the lenders' position when shareholders decide on dividends?) Law can in such instance be an efficient supplement to contract;

¹ Bergström, C., Samuelsson, P. (2001) *Aktiebolagets grundproblem*, Nerenius & Santérus Förlag

then transparency is important, as also restrictions are in order to not inflict on other contractees' interests when subsequent contracting takes place.

A subsequent question is whether law should be mandatory or non-mandatory? A legislator can never predict every form of opportunistic behaviour, and the potential efficiency gain that can be made by mandatory legislation has to be justified by that it up-weighs the efficiency loss that mandatory law creates. Every country has laws; the question is to what extent laws should be mandatory, if at all? However, this thesis will deal with the principal question on Institutional Competition, i.e. the possibility to choose law.

1.2 Two different Approaches

The United States and the European Community have chosen two opposite ways of managing the corporate law at the “federal” level. Intently to ease and proliferate the ways of doing business across the respective community, they have pursued different paths in order to give the businessmen their structured corporate heaven.

The US has let the states compete with their corporate laws (i.e. *Institutional Competition*), with the idea of letting “the market” choose and develop the best corporate law. EC, on the other side, have chosen to try to harmonise the states' different corporate laws; a tremendous challenge of melting a rich flora of organically developed corporate laws together, several of them emanating from the 19th century.

As modern information technology has created the “Glocal” community, more and more corporations are truly global in their approach to the world and therefore no longer bound by the ties of their state of origin. With employees all over the globe, major markets in every corner of the world

and a turnover that would make small countries such as Sweden jealous², a truly global company will likely reside where it can benefit the most from, for example, corporate law structure and taxation pressure.

Several companies can without further delay choose to be incorporated somewhere in the US or in the EC. Strong lock-ins, due to e.g. government relations and long-term geographical presence, probably affect the likeliness of a move, although the trend seems to be that large corporations to far less extent consider factors that do not influence shareholder value. (Not saying that these lock-ins lack significance.) In the US, *shareholder value* is the predominant factor that influences every major corporate decision, while in Europe this has not always been the case. However, the constituency models of the corporation are now being abandoned also in Europe as the ownership structures are changing and the companies are getting increasingly international. For instance, company X might have its owners scattered all over the world, mainly conducting business in the countries A, B and C, while its headquarter is located in country D. Thus, a particular state's bargaining power is diminished in relation to the company and the state's possible claims on the company will likely diminish accordingly. Several factors contribute to the states' difficulties of controlling trans-national companies: for instance an increasingly de-regulated world, with high level of information transparency, the largest corporations size in combination with their influence and ever more efficient capital markets.

I believe, the different approaches, respectively chosen by the US and the EC, should be understood in the above-described context. Thus, this thesis will try to draw on the tools and frameworks of *Law and Economics* in order to compare *Institutional Competition* and *Harmonisation* in the field of

² Although "turnover" and "GDP are not directly commensurable, a comparison can be done as to the sizes of modern corporations and nations. '[t]he combined revenues of just General Motors and Ford ... exceed the combined GDP for all of sub-Saharan Africa', Dine, J. (2000) *The Governance of Corporate Groups*. Cambridge University Press. Further, "...51 of the 100 largest economies are corporations...". See Anderson, S., Cavanaugh, J. (1996) *The Rise of Global Corporate Power*, Institute for Policy Studies, Washington DC

Corporate Law. Institutional Competition or Harmonisation are generically different approaches whenever a federation's member states have enough independence to stipulate their own laws; for instance the tax competition between the member states is of major concern to the European Community at the moment. In the United States the debate has shifted in favour of the Institutional Competition, whereas in Europe such competition is considered as *a race to the bottom*.

My notion is that corporate laws can be considered as services, or products, which give certain implications. In the case of competition implying that the mean of competition between the states is their corporate laws and the perceived customer value settles the outcome of the competition. Whereas in the case of harmonisation there will merely be one flavour of corporate law. If so, they better make that one a good one!

Traditionally the corporation is said to have two major problems; firstly it is the need for protection of its shareholders and secondly, it is the call for protection of its financiers.³ With the corporations', often, diverse ownership structures the aim of maximising shareholder value might be in danger since management can choose to enrich themselves instead of the shareholders, i.e. the classical agent-principal relationship. Further, as the limited liability opens a window for opportunistic behaviour against financiers, governments have always been suspicious against the limited liability of the corporation. Idealistically, the corporate law thus can lower transaction costs by signalling and ease information gathering, making it safer for the shareholders as well as potential financiers and contractual parties.

It is a classic problem: The greatness of the corporate form is its ability of drastically lowering transaction costs. Instead of negotiate and contract with any party, the corporation replaces all those contracts with an overall

³ Bergström, C., Samuelsson, P. (2001) *Aktiebolagets grundproblem*, Nerenius & Santérus Förlag

standard contract; but the transit from market to hierarchy lays the power in the hands of the co-ordinator of the corporate resources, which causes agency costs due to governance difficulties inherited in the corporate form. In order to achieve efficiency, should common law (or equivalent), the corporate certificate or contracts rule the corporation? Also, the question is whether mandatory or non-mandatory ruling is the appropriate solution? Depending on how one look upon the role of the corporation in society and the conflicts of interests between Management-Shareholders, Majority-Minority and Shareholders-Creditors, different standpoints to Institutional Competition have been taken.

In Europe, Sweden takes a middle position between UK and Germany. UK is closely related to the USA, the common law family has much of a “laissez-faire”-approach to the corporate law whilst Germany takes the other flank with their strong “stake-holder” perspective. The European countries have, without debate, presumed that Institutional Competition is dangerous since it would diminish investor protection. Hence, the decision to harmonise the European corporate laws. I find it interesting to compare the different approaches in a Swedish context. Possibly this study can contribute to further contemporary debate on *Institutional Competition*.

1.3 Purpose

The purpose of this thesis is to apply an economist’s view, of the corporate law in general and on the corporation in particular, in order to schematically study the feature of Institutional Competition from a law & economics perspective.

1.4 Delimitation

- The theories regarding Corporate Governance is foremost related to the larger corporation, and the focus will therefore be on the larger corporations. However, stakeholders are not only shareholders,

financiers and the minority holders, but also the smaller enterprises since they are depending on the same regulation. When applicable, the discussion will therefore encompass also the smaller corporation.

- I will merely study Institutional Competition versus harmonisation regarding corporate law, thereby disregarding fields of study such as tax law. Naturally, since this is a Swedish thesis, the Swedish corporate law situation will be of particular interest. Moreover, the Swedish corporate law is chosen as comparison object also because of it representing “continental Europe” that often is said to adhere to a more protective law regime, than is the case in the common law tradition.⁴

1.5 Method

I will in this thesis use the Law and Economics approach. The basic principle of this theoretical approach is an application of economic principles to legal institutions, instruments, questions and procedures. The basic notion is that all judicial decision-making shall be consistent with economic efficiency. For example, Law and Economics studies can aim to examine whether the corporate law is evolving in a more efficient manner.

The major concern from Swedish law scholars regarding the Law and Economics as a method is the argued lack of perspective on “fairness”. However, the application of the method does not give any answers to such issues. It is my intention to analyse *Institutional Competition* versus *Harmonisation* in a European context, and the background is more related to relative competitive strength than philosophical questions on fairness. That is, the Law & Economics perspective presumes that a more efficiently organized society has a larger pie to part, however its distribution is an entirely different question.

⁴ For instance taxation is another field of great concern to the harmonisation process within the EC. As today, several member-states seem to compete on taxation.

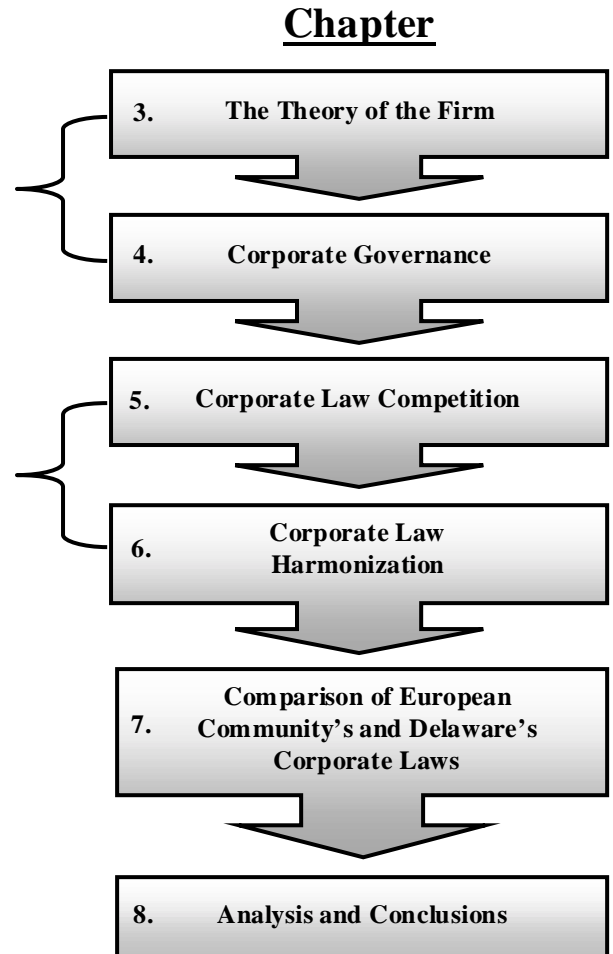
As many potential readers are not familiar with the tools of the Law & Economics approach, I will account rather extensively for the different theories within the field.

1.5.1 Definition of the Efficiency Criteria

Concepts of the measurement of efficiency vary. *Pareto Efficiency* requires that someone gains and that no one loses. On the other hand, *Kaldor-Hicks Efficiency* requires merely an outcome where someone gains and potentially can compensate fully all losers and still remains better off. However, the corporation's residual income goes to the easily identified shareholders that have fixed shares of the corporation, *efficiency* should in this context therefore be understood as *shareholder value maximisation*.

1.6 Disposition

The disposition of the thesis is structured as shown to the right. Chapter three and four, “The Theory of the Firm” and “Corporate Governance”, set up the theoretical framework for the thesis. For the experienced reader of law and economics related studies, these two chapters should not bring anything fundamentally new. In the following, chapter five and six, come the two empirical sides of the coin; “Corporate Law Competition” accounts for the American debate that has resulted in homogeneity among scholars in the US, and “Corporate Law Harmonisation” deals with the European harmonisation process and its implications. Chapter seven “Comparison of the European Community’s and Delaware’s Corporate Laws” addresses the issue of possible divergence in member states’ corporate law structures between the two systems. Finally, chapter eight “Analysis and Conclusions” is where the thesis final analysis and conclusions are to be materialised.



2 The Theory of the Corporation

The main feature of the corporate form, i.e. that it enables several individual contracts between a multitude of parties to be replaced by a *nexus-of-contract*, and its inherent problems, is thoroughly discussed in the well-known works of Easterbrook & Fischel and Bergström & Samuelsson.⁵ They replicate back to the standard works of Coase, Demsetz and Jensen & Meckling to name a few,⁶ which all have inspired me during the writing of this thesis.

2.1 The Corporation

Naturally, corporations are products as well as part of society. Various models of the corporation are therefore shaped in different contexts, which have different views of the corporation's role in society. A coherent reasoning regarding corporate law cannot overlook the significance of the "organic conception" of the company, as depending on which theory of the companies' existence is favoured different corporate governance models will be relevant. I will not account for all different theories concerning the existence of companies. However, *the contractual view* of the firm stands somewhat as the opposite pole to the other extreme theory, *the communitarian theory*, since they represent notions on the company as laissez-faire individualism and as an instrument of the state, respectively. The different point of views affect the degree of state interference that is considered appropriate, as well as the range of interest that the company should take care of.⁷ Most adherents to economic analysis of the corporation

⁵ Easterbrook F. H., Fischel D. R. (1991) *The Economic Structure of Corporate Law*, Harvard University Press, Bergström, C., Samuelsson, P. (2001) *Aktiebolagets grundproblem*, Nerenius & Santérus Förlag

⁶ See for example Coase, R. H. (1937) *The Nature of the Firm*, *Economica* N. S., Demsetz, H. (1968) *The Cost of Transacting*, *Quarterly Journal of Economics*, 82, Jensen, M.C., Meckling, W.H. (1976) *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *Journal of Financial Economics*, 3, p. 305-360

⁷ For a summary of the different theories of the company see Dine, J. (2000) *The Governance of Corporate Groups*. Cambridge University Press

believe the company to be more of a voluntary association between shareholders than a creation of the state.

Macey states that the most important lesson learned when it comes to economic analysis of the corporation is realising that the company is made up of a complex nexus of contractual relations; i.e. the corporation is not a person. However, the view of the company as a *nexus of contracts* does not actually give an answer to what the company is, it merely changes the prerequisites for the debate.⁸

The corporation acts like the market as it works like a “complex equilibrium process” in which all stakeholders of a company take part; e.g. employees, suppliers, customers, creditors and shareholders are all part of this process.

The role of the legislator should under this paradigm first and foremost be to decrease the costs related to the contractual relations within the corporation.⁹ Thus, corporate law can decrease the high costs of reaching individual bargaining with every involved person. Further, the economist’s classical standpoint concerning the sole purpose for the company is to make money to the shareholders; *‘Corporate law establishes a set of off-the-rack legal rules that mimic what investors and their agents would typically contract to do. Most shareholders, it is assumed, would contract with the business managers to ensure that the managers seek to maximize profit.’*¹⁰ However, there is a discussion on the goal for the corporations; though, most participants seem to adhere to the quote above, I would not dismiss the importance of the others as insignificant.¹¹

⁸ Macey, J. R. (1993) *Svensk aktiebolagsrätt i omvandling*, SNS Förlag

⁹ Ibid.

¹⁰ Greenfield, K. (1997) *From Rights to Regulation* in Pathfield, F. (ed.), *Perspectives on Company Law: 2*, Kluwer, p 10

¹¹ The debate is commented in Bergström, C., Samuelsson, P. (2001) *Aktiebolagets grundproblem*, Nerenius & Santérus Förlag. The authors themselves rely on the stock market; the stock price is reflecting the Net Present Value of future profits. Whatever action the company takes will be evaluated, altruistic or not. (This is true to some extent, though the implications studied in *Behavioral Finance* might hurt the perception of the mechanisms behind the stock market as being rational.)

2.2 The Corporation or the Market?

Nobel Prize awarded of 1991, Ronald Coase, explains to us why we have firms. “Transaction costs” is the answer. Because of the fact that transaction costs exist, manoeuvring in the marketplace has a price, and companies replace the price-mechanism of the market. Due to the hierarchy there are less transaction costs within the company than on the market; i.e. the resource-allocation within the company is a result of administrative decisions and not a market transaction. Companies are perceived as a method of reducing the cost of a complex market consisting of a series of bargains among parties.¹² By organising under the regime of a standard contract, i.e. the corporation, there is an immense impact on the transaction costs since all individual contracts are replaced.¹³

However, there is no absolute definition of transaction costs. Coase never uses the term in his famous article, “The Nature of the Firm”¹⁴, instead he discusses the “*cost of using the price mechanism*”. Arrow talks about “*the costs of running the economic system*” and Demsetz¹⁵ defines them as “*the costs of exchanging ownership titles*”. Williamson is probably one of the most famous “transaction cost economists”, well known for his “Markets and Hierarchies”¹⁶ and “The Economic Institutions of Capitalism”¹⁷. He also does not have a clear definition, but he points out that a transaction can involve one or several actors and may be executed within or between corporations. That is, there can still be transaction cost within a company.

¹² Belcher, A. (1997) *The boundaries of the Firm: the Theories of Coase, Knight and Weitzman*, 17, Legal Studies 22

¹³ Further, principal-agent theory supplement the transaction cost theory by explaining the success of the (limited liability) corporation, namely that limited liability decreases the need to monitor agents as well as other shareholders. Also, it makes it possible to diversify holdings thanks to the specialised risk bearing made possible by the corporate form. Authors like Demsetz build on Coase’s theory as they argue the corporation to be a result of the governance problem of teamwork collaboration. See further on corporate governance below.

¹⁴ Coase, R. H. (1937) *The Nature of the Firm*, *Economica* N. S.

¹⁵ Demsetz, H. (1968) *The Cost of Transacting*, *Quarterly Journal of Economics*, 82

¹⁶ Williamson, O. E. (1975) *Markets and Hierarchies*, The Free Press

¹⁷ Williamson, O. E. (1985) *The Economic Institutions of Capitalism*, The Free Press

The boundaries for the company's size will be where its costs for organising a transaction is as high as would be letting the market take care of the transaction. This will decide what the company will buy, produce and sell.¹⁸ Of course, there can be companies that are more efficient than others, perhaps as a result of them benefiting from scale; sometimes the alternative for the company therefore might be to let some other company take care of a certain function or production, i.e. outsourcing.¹⁹

A useful metaphor might be that “*transaction costs play the same role within the economic system as does friction in mechanical physics*”.²⁰

The theory on *opportunity costs* is supplementing the notion on transaction costs. According to Fahlbeck, both Coase²¹ and the later Buchanan²² points out that “costs“ which are unchanged with respect to a specific decision are to be treated as sunk costs and therefore are without relevance to the current decision. Williamson, further, talks about a dimension of specificity that adds to traditional accounting costs (fixed and variable costs), for simplicity divided into specific or non-specific. He argues that traditional accounting misses the different contract costs. In short, a specific asset has a drastically lower value in alternative use, which should explain why opportunity costs become central to the issue of costs.²³

2.3 The Market

According to economic theory, agent costs are the main costs of organising the business within the corporation, and the foremost costs of market transactions are transaction costs.

¹⁸ Coase, R. H. (1992) *Företaget, marknaden & lagarna*, RATIO

¹⁹ Do not confuse this discussion with the advantages of having high enough level of production to break up the transaction costs on. My remark.

²⁰ Fahlbeck, E. (1996) *Essays in transaction cost economics*, Swedish University of Agricultural Sciences, Department of Economics, Uppsala

²¹ Coase, R. H. (1937)

²² Buchanan, J. M. (1978) *Cost and choice*, University of Chicago Press, (reprint, originally published 1969)

Markets are institutions aiming to make trade easier and less costly, i.e. in order to decrease transaction costs when trade take place.²⁴ The forum for the exchange shifts in its appearance, from the classic marketplace with its stands to the stock exchange to virtual marketplaces at the Internet.

These facts imply that the role of the legislator should be to strive for the stipulation of laws that minimise the transaction costs. In that way the resource allocation more likely will be efficient.

2.4 The Characteristics of the Corporation

Normally, the distinctive features of the corporation are said to be limited liability, legal identity and perpetual existence. (Perhaps also the centralised and specialised management of the corporation belongs to these features.)

Of course, the limited liability is more of an attribute of the investment than of the corporation. This construction has several benefits, i.e. investors do not put at risk more money than they once invested and can by investing in several different companies and industries diversify their risk.

Legal identity and perpetual existence means that the corporation lasts until dissolved and has a name in which it may transact and be sued.²⁵ Naturally, these features lower transaction costs.

The last two features probably explain why we so easily think of the corporation as an “it”, a person of its own.

²³ Williamson, O. E. (1985)

²⁴ Coase, R. H. (1992) *Företaget, marknaden & lagarna*, RATIO

²⁵ Easterbrook F. H., Fischel D. R. (1991) *The Economic Structure of Corporate Law*, Harvard University Press

2.5 Briefly about *Rationality, Allocation Efficiency and Information*

An economic notion is that there are unlimited human wants, but only limited available resources; therefore we all have to make choices in order to decide what to produce or to consume. When we make these choices we forego opportunities which thereby have costs associated with them. (See 3.3.) Differently put, there is “no such thing as a free lunch”.

Economists assume that individuals make their choices in a rational fashion. Rational actors thus make decisions so as to improve their personal well being, wealth or as it also is referred to, their “utility”.

It is important to stress that no attempt, under economic theory, is made to try to explain why individuals prefer one thing or another. Instead, the actor is regarded as the best judge of his own welfare. According to people’s own preferences they try to maximise their personal wealth.

Further, rational actors participate in voluntary exchange in order to increase their joint welfare. Assume A owns five apples and the value he attaches to his fifth apple is £1. B owns no apples and will pay up to £1.10 for getting one. Under these circumstances, both parties will be better off if B buys the fifth apple for any price between £1 and £1.10. Economists assume that if A and B are rational and are properly positioned to negotiate and execute the transaction, this exchange will occur. Further, if A values his fourth apple to £1.10 and B is only willing to pay £1 no further trade would take place. Thus a simple equilibrium would be the outcome. Moreover, economists would characterise the outcome as efficient.²⁶ In other words, when assets are being employed in their most highly valued use, then economists say the resources are being used efficiently, and no further exchange will take place.

²⁶ The example comes from Cheffins, B. R. (1997) *Company law: Theory, Structure and Operation*, Oxford University Press

3 Corporate Governance

Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.²⁷ That is, the question is all about how controlling the managers once they have got the funding.

In the literature there are several different theories of how to approach issues related to ownership, control and the separation between ownership and control. Most of the frameworks emanate from studies of United States or Japanese corporate governance systems when analysed from an American perspective.

An overview over the Corporate Governance literature comprise four main classes of economic models of ownership, governance or group structures:²⁸

1 Vertical Integration models are found in the Industrial Organisation literature. The effect of ownership structures on market behaviour determines the ownership structure.

2 Principal-Agent Theory is the most popular approach. Whenever corporate governance is discussed in the business world or the financial press, reference to this theory is made. It raises the question of how the financiers assure themselves of getting return on their investments. Under the assumption that managers do not always have the fulfilling of the interests of the owners as their main goal, it tries to find the proper corporate governance structure.

²⁷ Shleifer A., Vishny R. W. (1997) *A Survey of Corporate Governance*, The Journal of Finance, Vol. L LII, No. 2, p.738-783, June

²⁸ See Becht, M. (1997) *Strong Blockholders, Weak Owners and The Need for European Mandatory Disclosure*, European Corporate Governance Network
<http://www.ecgn.ulb.ac.be/ecgn/2001-01-24>

3 Transaction Cost Theory, stipulates that it is more costly to transact between those inside and them outside a company than between those inside a company. (See chapter 2)

4 Incomplete Contract Theory, the firm allocates control to those with entrepreneurial skills and who are most indispensable in a world where contracts are costly to write and usually incomplete. The theory assumes that contracts cannot account for all contingencies that may arise.

The different approaches are to great extent complementary and I believe that in order to fulfil my purpose it is sufficient to draw on *Transaction Cost Theory* and *Principal-Agent Theory*.

3.1 The Agency Problem

The agency problem is an essential element of the contractual view of the firm due to the separation of ownership and control. In general, an agency relationship is “*a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent*”.²⁹ These agents may take advantage of the situation by self-dealing at non-arms’-length prices; they may trade in the firm’s stock on the basis of inside information; or they may provide themselves with excessive perks etc.

The issue is not new, but has been discussed already by Adam Smith:

“The directors of (joint stocks) companies, however, being the managers rather of others people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour and very easily give

themselves dispense from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.”³⁰

The managers need funding and the investors need the specialised human capital of the managers to generate returns on their investments. Managers either cannot generate enough capital or are just trying to diversify their risk by not placing all their assets, i.e. both their human capital as well as their financial assets, in one basket. Investors bear the most of the risk of business failure and in return they receive the greater part of the reward in case of success. Those who have wealth can diversify their investments; thereby reducing their risk, and the penalty for this is potentially increased agency costs since employees will receive less of the return along with a scattered ownership resulting in a less effective monitoring of the companies. The reason for this is that with a scattered ownership monitoring becomes a public good. In other words, investors face their own agency costs, which is why investors in public firms often are ignorant and passive.³¹

In reality, our rationality is bounded making it impossible to create complete contracts; the managers and their financiers have to allocate residual control rights – i.e. the rights to make decisions in circumstances not fully foreseen by the contract. The only situation where agency costs are completely eliminated is when the firm is wholly owned and managed by one person; this is naturally not the case for the public company.

Since a manager, does not always have the fulfilling of the interests of the owners as his main goal, the owner will be forced to spend resources on some kind of a monitoring system in order to keep track of the agent’s

²⁹ Jensen, M. C., Meckling, W. H. (1976) *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, Journal of Financial Economics, 3, p 305-360,

³⁰ Smith, A. (1776) *The Wealth of Nations*

³¹ Easterbrook F. H., Fischel D. R. (1996) *The Economic Structure of Corporate Law*, Harvard University Press. Jensen and Meckling argue that in efficient capital markets, the agent bears the total wealth effects of total agency costs due to the investors’ possibilities of anticipating these costs. See Jensen/Meckling (1976).

behaviour. The continuing conflicts between the investors and the managers, together with the sum of the monitoring and bonding mechanisms design to reduce them, are what Jensen and Meckling call *agency costs*.³²

The principal reason that investors provide external financing to firms is that they receive control-right in exchange.³³ The external financing can be perceived as a contract between the investors and the managers. If the managers violate the contract, the investors may address the court to enforce their rights. Much of the difference in corporate governance systems around the world stems from the differences in the nature of legal obligations that managers have to the investors and in the differences in how courts interpret and enforce these obligations.³⁴ The managers are commonly considered being under a duty of loyalty, which within OECD countries is perceived as a strong concept; the protection of creditors is often even stronger than the protection of shareholders due to their contracts often being very straightforward.³⁵

No matter what monitoring or bonding mechanism is employed, some conflict of interest between outside investors and managers will generally continue. The legal protection of investors varies around the world and even in the United States, Germany and Japan (which countries probably are most concerned about the issue) managers still have considerable discretion about what is done with the money.³⁶ Shleifer and Vishny conclude that legal protection will not suffice to ensure the investors' interests.

Legal protection of investors, and ownership concentration, i.e. large share holdings, takeovers and bank finance, are considered complementary

³² See for instance Jensen, M.C., Meckling, W.H. (1976) *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, Journal of Financial Economics, 3, p. 305-360

³³ Shleifer A., Vishny R. W. (1997) *A Survey of Corporate Governance*, The Journal of Finance, Vol. L LII, No. 2, p.738-783, June

³⁴ Ibid.

³⁵ However, when the situation is as harsh as imminent bankruptcy, the creditors often renegotiate because of the (often) complicated bankruptcy procedures. Shleifer A., Vishny R. W. (1997) *A Survey of Corporate Governance*, The Journal of Finance, Vol. L LII, No. 2, p.738-783, June

³⁶ Ibid.

approaches to governance. For instance the threat of a hostile takeover is a strong incentive for managers to remember to place the shareholders' interests before their own. Should not the internal control mechanisms keep agent costs at bay, the corporation becomes a target for a hostile takeover. By appointing a management that better acts in the interests of the shareholders, the new owners can thereby minimise the agency costs.³⁷ Otherwise the most common feature for getting the agency costs under control is aligning the interest of the managers with the best interest of the investors by incentive contracts. Typically such incentives have to link some measure of performance that is highly correlated with the quality of managers' decisions (and ultimately can be verified in court) with the managers' pay. Also, managers invest reputation in acting to the benefit of the investors; their "market value" would certainly decline in case they did not stick to some form of "honourable conduct".

An alternative approach would be ownership concentration by a few major shareholders, i.e. as in continental Europe. However, although large investors can be very effective in dealing with agency costs they can also ineffectively redistribute wealth from small investors to themselves. The same discussion as between shareholders contra managers therefore might be applicable to the power-balance between large majority holders and minority shareholders.

3.2 Agency Theory and Firm Structure

Jensen and Meckling adhere to the above-recommended definition of what constitutes a firm, namely a legal fiction that serves as a *nexus of contracts* among various factors of production. In this sense the "behaviour" of the firm is like the behaviour of the market; i.e. the outcome of a complex equilibrium process.³⁸

³⁷ The threat for the managers should not be neglected: "*Within three years of an acquisition, half of all managers at targets are out of work*" Easterbrook, F. H., Fischel, D. R. (1996) *The Economic Structure of Corporate Law*, Harvard University Press, p.162

³⁸ Jensen, M. C., Meckling, W.H. (1976) *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, Journal of Financial Economics, 3, p. 305-360

Fama and Jensen develop this theme further in later work.³⁹ Initially they generalise the discussion of the agency relationship from the specific example of the relationship between managers and investors, they then develop this reasoning studying the relationship of any two stages of the decision-making and implementing process. The authors argue that any decision-making process can be broken down into a series of stages that different individuals or groups of individuals will specialise in. Such specialisation enhances the decisions-making skill of particular parts of the decision but also creates agency problems because of the interdependencies between the different stages that will be the result of the specialisation.⁴⁰ Further, Fama and Jensen state that a wide variety of organisational structures and processes can emerge to reduce these agency problems, which ones depend on the characteristics of the agency problems and the stages of the decision-making process that are involved.⁴¹

Adherents of the theories related to the notion of *nexus of contracts* realise the many different complex constructions of companies that is the result of the companies dealing with their different agency costs. They advocate the legislator's main goal to be decreased costs of conducting business within the corporation by flexible, and non-mandatory corporate law in the form of a standard contract.

³⁹ Fama, E. F., Jensen, M. C. (1983) *Separation of Ownership and Control*, Journal of Law and Economics, 26, p. 301-325

⁴⁰ Barney, J. B., Ouchi W. G. (eds.) (1986) *Organizational Economics: [toward a new paradigm for studying and understanding organizations]*

⁴¹ Fama, E. F., Jensen, M. C. (1983) *Separation of Ownership and Control*, Journal of Law and Economics, 26, p. 301-325

4 Corporate Law Competition

4.1 A Race to the Bottom or to the Top?

The USA is a federation where corporate law is not a federal issue. This fact has not always been undisputed; as late as during the 70:ies, 80 law professors from 62 law schools signed a proposal to the congress, where they argued that the corporate law ought to be handled at national level. They reasoned that the member states corporate laws enable the management to gain on the owners' expense.⁴²

The scholars who oppose Institutional Competition are often called "federalists" since they advocate increased corporate regulation at federal level. Due to the scattered ownership-profile in the corporate America, the federalists believe the management of a company to make the actual decision to reincorporate; hence they will choose to reincorporate in the state that offers the most favourable position from their point of view. The federalists argue that this has led to erosion of the corporate laws, for instance provisions can nowadays be derogated from the re-incorporation charter or by-laws of a company. Moreover, it is possible for the management to make some changes in the by-laws or incorporation charter without shareholders' consent.

Thus, the federalists argue that Institutional Competition holds the risk of allowing management to act opportunistically since the directors' obligations to shareholders are diminishing. Accordingly, the advocates of legislation on national level argue that the competition among states is a race for the bottom because they believe the unfettered discretion of managers' is diminishing the shareholders' assets. This conclusion comes from the studying of the corporate law of Delaware, since it is the most

⁴² Bergström, C., Samuelsson, P. (2001) *Aktiebolagets grundproblem*, Nerenius & Santérus Förlag

favoured corporate law by the largest corporations for the purpose of re-incorporation.⁴³

William Cary was one of the first in the modern debate on the issue of state competition in corporate law; he saw a failure in the financial and product markets, as well as in local politics. As Cary studied the old tradition of Institutional Competition he noticed that Delaware was winning the battle by removing several for the management constraining rules, in combination of favouring them in court. He argued that the financial market did not digest the information of the value of different legal rules, or even if so, the products market do not functioning properly or the costs of a takeover are substantial and therefore the shareholders have nothing left but voting by their feet.⁴⁴ Further, Cary argued that the political process at the state level is led by the desire for tax dollars and he pointed out the close relationship between legislators, judges and corporate law firms in a small state, which tax collection to 1/4 comes from franchise taxes. Romano remarks insightfully that Cary left unexplained why national legislators in pursuit for re-election would be less receptive to managers' political influence than state legislators.⁴⁵

The other classical position in the debate was originally formulated by Ralph Winter. He argued that Gary had overlooked the many markets in which companies operate, i.e. the markets for capital, product and corporate control, and to constraining managers from choosing to try to adopt a legal structure that is not in the best interest of the shareholders. Winter agreed upon Cary's characterisation of the power of competition in producing laws that firms demand. Winter, however, pointed out that firms operating under a legal regime that did not maximise company value would be outperformed

⁴³ "Delaware, the second smallest state in the nation, is the home of nearly 60 percent of the companies listed on the New York and American Stock Exchanges and more than half of the Fortune 500 firms." American Incorporators Ltd., www.worldwidecorp.com/, 2001-08-13

⁴⁴ Cary, W. L. (1974) *Federalism and Corporate Law: Reflections Upon Delaware*, Yale Law Journal, 83, p. 663-705

⁴⁵ Romano, R. (ed.) (1993) *The State Competition Debate in Corporate Law*, in *Foundations of Corporate Law - Interdisciplinary Readers in Law*, Oxford University Press

by companies that operate under a legal regime that did. The latter would correspondingly have higher stock prices. Winter concluded that the fear of losing their jobs would force managers to pursue a shareholder value maximisation strategy. After the critique of Cary's position the adherents had to amend the critique. Thus, the contention that markets are imperfect constraints on managers and, hence, there is sufficient slack in the system to produce non-value-maximising state laws.⁴⁶

The federalists view the state legislative process as a market failure in which managers are better organised than the more numerous but dispersed shareholders. Moreover, they recognise the managers' preferences for codes as diametrical opposite to the shareholders'.

4.2 Most Scholars adhere to “Race to the Top” Notion

Bergström & Samuelsson argue that probably no one of those 80 scholars above mentioned would sign such a proposal today. The mere insight that the management and the owners are two parties in a contractual relation, one party seeking funding and the other looking for potential projects to bet their money on, has changed focus in the US from the urge of protection of the owners against management's opportunistic behaviour to instead seeking to decrease transaction costs.⁴⁷ Supporters of competition assume management's freedom of action to be constrained as much, if not more, by market forces, which discourage the managers from acting in an opportunistic manner. If the management acts opportunistic it will show in the market of corporate control as the stock price inevitable will go down, and the threat of hostile takeover will increase accordingly.⁴⁸ In most cases the acquired company's management will shortly be replaced by the

⁴⁶ Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press

⁴⁷ Bergström, C., Samuelsson, P. (2001) *Aktiebolagets grundproblem*, Nerenius & Santérus Förlag

⁴⁸ The stock market has theoretically perfect information and the poor management will therefore result in a lower stock price, and an arbitrage profit will possibly for the acquiring company.

continuing company, creating strong incentives for the management to focus on value creation for the shareholders in order to keep their positions. Also, misbehaviour amongst management would show in their valuation on the market for managers.

The rationale for managers to pick the state which law is the most desirable to the investors is that this will attract the most money. Likewise, the state that selects the best combination of rules will attract the most corporate investment, and therefore increase the tax collection. In Europe there is no franchise tax, as in the US, instead the states collect taxes only if the company headquarter is physically placed in the state. The linear relation between states' responsiveness to firms in their corporate codes and tax revenues⁴⁹ might therefore not be fully analogous for Europe. However, strong arguments for the believe that states would benefit from incorporation in terms of, among other things, increased tax revenues still exist since European countries tax stock transactions and the issuance of shares, and also impose filing fees on initial incorporations.

The incentives for the companies to re-incorporate in Delaware are, however, not to decrease the tax burden. They actually pay a premium franchise tax in Delaware. In exchange, Delaware is specialising in servicing large companies. Moreover, the sole source of income that is somewhat certain if companies incorporate in a state is the franchise tax, that is collected irrespective of whether the company perform any business in the state or not. Company tax is collected in the state where the business takes place or where the head of the company is located. Delaware is the only state that can be said to be dependent on the income from the franchise, which should explain why the larger companies are getting the best of the judicial administration's attendance.⁵⁰

⁴⁹ Romano, R. (ed.) (1993) *The State Competition Debate in Corporate Law*, in *Foundations of Corporate Law - Interdisciplinary Readers in Law*, Oxford University Press

Since Delaware is strongly dependent upon the larger companies' incorporation, should the argument that they have found their safe harbour to avoid shareholder and investor protection be persuasive enough. As is shown in chapter six, the legislation is not void, although much is left to the courts to form by themselves. However, the specialised Court of Chancery of the State of Delaware, i.e. the most superior court in the state, is in dialogue with the US Supreme Court, which is not specialised, but that has full discretionary power under the certiorari rule.⁵¹

In the backwash of the articles of Cary and Winter, several empirical studies have tried to arbitrate the debate over who actually benefits from Institutional Competition on corporate laws, shareholders or management? The method has been financial econometric techniques, which investigates whether particular information events have significantly affected companies' stock prices. If an information event, i.e. in this instance, reincorporating in Delaware, is considered beneficial to the shareholders (i.e. enhanced value of their equity investment), the stock prices will rise significantly on the public announcement. If the event is considered to hurt shareholder value, correspondingly, the stock prices will go down on the announcement of the event.

There have been five event studies of re-incorporation.⁵² Several of the studies show significant correlation on firms' re-incorporation to Delaware and positive stock price effects, whilst *no* study has found a negative stock price effect, as Cary would predict. However, some federalists question whether the event studies indicate investors' evaluation of the new state's regime due to possibly confusing signals. Bebchuk and Eisenberg argue that if a re-incorporation announcement is accompanied by disclosure of a new

⁵⁰ In most states the franchise revenue accounts for below one percent of the total taxes collected, with the state of Delaware as the strong exception. See Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press

⁵¹ Certiorari: "A writ, issuing from a superior court, upon the complaint of a party that he has not received justice in an inferior court, or cannot have an impartial trial, by which the records of the cause are called up for trial in the superior court."

⁵² As accounted for in Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press

corporate strategy, a positive stock price reaction might be attributed to investors' assessment of the new strategy and not of the statutory domicile.⁵³ In return Romano finds it unlikely that such information could swamp a re-incorporation's otherwise significant negative stock price reaction. She argues that if the notion of Bebchuk and Eisenberg would be correct the offset effect would not hide the significant negative effect for companies changing domicile. The stock price effect is not significantly different across companies reincorporating for different business purposes, that is, there is no difference between instances when management is planning to undertake activities that are considered adverse to shareholders' interests and those that are not criticised by outside commentators.⁵⁴

Romano draws further evidence on the success of Institutional Competition, from the corporate innovation of permitting firms to limit managers' personal liability for damages in shareholder suits. In this instance, Delaware was originator, with 41 states as followers within two years. If Cary's claims had been valid, significant stock price decreases would have occurred for both firms reincorporating to Delaware, to take advantage of the statute, and for Delaware firms on the statute's enactment. The event's outcome was that firms, which took advantage of the statute, experienced either "...significant positive abnormal returns or positive abnormal returns bordering on conventional statistical significance...".⁵⁵

⁵³ Bebchuk, L. A. (1992) *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, Harvard Law Review, vol. 105, pp.1435, Eisenberg, M. A. (1989) *The Structure of Corporation Law*, Columbia Law Review, vol. 89, pp. 1461. See comments in Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press

⁵⁴ Romano, R. (1985) *Law as a Product: Some Pieces of the Incorporation Puzzle*, Journal of Law, Economics, and Organization, vol.1. Moreover, Romano points out that shareholders must approve a re-incorporation, and SEC requires detailed information on differences in legal regimes in proxy materials, therefore is not likely that shareholders would approve a destination state whose regime is adverse to their interest. See Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press

⁵⁵ Significance at 10 percent. See Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press, p. 21

5 Corporate Law Harmonisation

The European Community has chosen to avoid Institutional Competition and is instead trying to harmonise the European corporate law. The harmonisation process has so far been focused on the relations between the corporation and third party. The enactment of the Fifth Directive (concerning worker participation/codetermination) has failed despite considerably efforts and compromises during preparation.

The tremendous difficulty in arriving at a compromise on the proposal for the Fifth Directive is primarily due to the same controversies as have been an obstacle at the member state level. The different laws have rather recently been enacted in the member states themselves,⁵⁶ and reaching consensus at an even higher level of politics is not easily done. The member states are heterogeneous when it comes to the structure of the corporate organisation and management. Most, but not all of the European nations, take a so-called enterprise approach to the corporation, i.e. a stakeholder perspective, which requires the representation of employees as well as shareholders in corporate decision-making. For instance Germany (and other countries influenced by German law) has a dualistic system with one board representing the owners and another representing other stakeholders. Meanwhile the UK (“common law countries”) has a monistic structure with a sole board of directors representing the owners. The more diverse law structure within the EC, the more difficult it is coming to a closure during the process of preparation and enactment.

5.1 The European Community considers the “Delaware Effect” a Race to the Bottom

The overwhelming goal for the harmonisation is to dissolve potential threats against the free movement of goods, services, labour and capital. By posing

common minimum requirements on the *Corporate Europe* this movement will flourish, one argues. When the so-called *Delaware-effect* is referred in the debate this effect is referred to as a *race for the bottom* due to the conclusions made by William L. Cary in 1974. Hence, in the European debate the Delaware effect has been one of the strongest argument for harmonisation, initially with the Netherlands as the potential European “Delaware”, now the Great Britain has taken over this role as it is considered having a too liberal corporate law.⁵⁷

Traditionally, the European Law culture adhere to a stakeholder perspective, i.e. constituency models of the corporation is underlying the corporate laws in most European countries. Commonly Europeans fear not only, the Institutional Competition to weaken the corporate law’s protection of shareholders, but also the deterioration of the other stakeholders’ position. The European model, or the *enterprise approach* to the corporation, which for instance requires employee representation as well as shareholders’ in corporate decision-making, is recognised as unsustainable if there would be Institutional Competition.⁵⁸

Due to the above-mentioned perceptions of the Delaware effect’s dangers, it is today not possible to “forum shop” within the EC without having to overcome severe obstacles. If for instance, the corporation tries to register in a different member state it will likely be liquidated in its state of origin and then will have to incorporate in the new state; liquidity taxation will then probably occur. However, to some extent a few countries support re-incorporation, e.g. Great Britain, Ireland, Netherlands, Sweden, Finland and

⁵⁶ Buxbaum, R. M., Hopt, K. J. (1988) *Legal Harmonization and the Business Enterprise: Integration Through Law*, Vol. 4

⁵⁷ Ensig Sørensen, K., *Udenlandske selskabers omgøelse af nationale kapitalkrav*, in Langsted, L. B. (1999) *Selskabers kapital- Nye tendenser i skandinavisk selskabsret (3)*, Jurist- og Økonomforbundets Forlag

⁵⁸ The European approach is questioned whether it maximises shareholder value. Worker co-determination would probably be opted by American companies if it enhanced shareholder value, but they do not. For a summary of the debate on shareholder value and the European model, see Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press, pp. 128-140.

Denmark.⁵⁹ Further, there might be a swift change due to the recent case of *Centros Ltd. v. Erverhaus – og Selskabsstyrelsen*,⁶⁰ where Denmark was held unable to insist on minimum capital requirements that would have hindered a UK company from registering in Denmark. The company had been legally formed in the UK but did not carry on any business there and intended to operate solely in Denmark. The court disregarded the argument that the company merely tried to circumvent the Danish minimum capital requirements. This might imply that the court is moving towards adopting the incorporation theory.⁶¹

As a comparison, since a hundred years, it is accepted in the United States that the use of a corporate body from another state is not to be considered as *fraud on the law*.⁶² The work with the proposals on the 10th and 14th Directives also points in this direction in so much as an adoption of the former Directive would enable mergers with participants from several countries, whereas the latter Directive's adoption would enable companies' shift of nationality without them being liquidated.⁶³ However, due to the in most member states prevailing choice-of-law rule, the nations follow the law of a company's real or effective seat (*siège réel*) rather than of statutory domicile, i.e. registered office. For most companies this has until now made it utterly expensive to re-incorporate. The *Centros*-case might change the importance of also the choice-of-law rule, but it is hard to predict the level of resistance among the different interest groups.

The creation of a common market has created powerful institutions in Brussels and Strasbourg with the main objective of harmonise ever-wider areas, above all addressing economic issues but also such things as human

⁵⁹ Søndergaard Birkmose, H. (2000) *Konkurrence mellem retssystemer inden for selskabsretten i EU*, Nordisk Tidsskrift for Selskabsret No. 3-4 2000

⁶⁰ *Centros Ltd. v. Erhvervs- og Selskabsstyrelsen*, Case C-212/97, [1999] ECR I-1459

⁶¹ Dine, J. (2000) *The Governance of Corporate Groups*

⁶² See references in Ensigt Sørensen, K., *Udenlandske selskabers omgåelse af nationale kapitalkrav*, in Langsted, L. B. (1999) *Selskabers kapital- Nye tendenser i skandinavisk selskabsret (3)*, Jurist- og Økonomforbundets Forlag

⁶³ This should probably make it possible to avoid taxation due to the move.

rights.⁶⁴ Although the *Centros*-case might change the notion of fraud on the law, there will soon be a rather fully covering harmonised corporate law in the Community, which the companies cannot get round, thereby the incentives for forum shopping will likely diminish.

The motives for the European harmonisation of the corporate law foremost seem to be to avoid two things: firstly, hindrances against the free establishment of corporations, and secondly the “Delaware effect”. There is only a vague co-ordination between the different Directives. Hopt and Buxbaum have scrutinised the Directives; hence they are harsh commentators:

*“Legal harmonisation can be a palliative for the failure of progress in truly European market integration, particularly if relatively minor side issues are taken up as second best candidates for harmonisation and if the dissent over the key issues is camouflaged by harmonisation of details and technicalities.”*⁶⁵

5.2 Mandatory Terms

A uniform European corporate law has to be in the form of directives to be thoroughly implemented throughout the Union. According to Gower, the Commission has expressed that Directives have to be implemented in a way that is “legally enforceable”, a prerequisite that only mandatory rules can uphold.⁶⁶

In order to fulfil the provisions in the Directives, the member states’ legislators and courts have to develop national rules that later should be tested by the European Court of Justice as to whether they are compatible with the freedoms of the Directives, and of course, the Treaty. This will

⁶⁴ Lundgren, N. (1996) *Institutionell konkurrens eller central harmonisering I*, in *Vad vill Sverige med Eu?* Konjunkturrådets rapport 1996

⁶⁵ Dine, J. (1991) *EC Company Law*, p. 5, London

⁶⁶ Macey, J. R. (1993) *Svensk aktiebolagsrätt i omvandling*, SNS Förlag

require an intense dialogue between the national courts and the European Court.

6 Comparison of European Community's and Delaware's Corporate Laws

The Swedish statutory laws are to a great extent mandatory and the experiences from the Kreuger-crash 1932 gave rise to strong protection of the corporation's financiers in the revised Corporate Law of 1944. When the corporate law was renewed in 1975 it was cut down as well as made easier to use. However not much lightened regarding the protection of financiers.

The Delaware General Corporation Law (DGCL) is user-friendly with its informative paragraphs that often are disposed in bullets displaying mandatory and non-mandatory sub-segments. In that way you easily get an overview and the non-mandatory segments illustrate as examples of how to address a particular problem. Thus maximum flexibility for the corporations is achieved.

Below, I will account for some of the most important features from each of the two corporate laws. Focus will be on issues that relate to the discussion on Institutional Competition versus harmonisation, i.e. whether it is a race to the top or a race to the bottom.

6.1 Formation

Both laws govern the incorporators and how the corporation is formed with a certificate of incorporation (Swedish "Stiftelseurkund"). The certificate is used similarly. Both stipulate that articles of incorporation should be in the certificate in order make prospective investors able to see them before they put any capital at risk.

In Delaware the certificate, extensive as it is, is further supplemented with by-laws. The latter are of less magnitude than the ones in the certificate;

together they make it possible to have one- and two-tier rules that regulate the company.

As already mentioned there is no rule of “siège réel” in Delaware’s corporate law, however there has to be a representative in the state; which one has to be noted in the certificate.

6.2 Protection of Minority Owners

In Sweden the minority can force the company to assign special minority auditors. The minority (10% or more of the shares) can also call for an audit of the management’s administration and as well as a financial audit. In both cases the county administrative board will appoint the auditor.⁶⁷

Further, in Sweden the minority can turn down the management’s discharge from liability and decide on claim the management for damages. On some important issues there have to be a qualified majority when voting since it has been considered especially important to the minority.⁶⁸

In both countries there is an appraisal remedy, i.e. the minority owners are entitled to appraisal and fair compensation when large changes such as mergers etc, take place. Appraisal gives investors the worth their shares had before the transaction, i.e. it is *Pareto efficient*.⁶⁹ This works both ways, when the majority holds more than 90% of the stocks, they can buy out the minority. Furthermore, the management’s liability follows in Delaware from its fiduciary duties; these are developed in case law but are rather far-stretched and should also be considered as protection to the minority shareholders as well as to the majority in case of hold-ups. Moreover, the court has declared that shareholders have a protected right in the form of their investment as well as in its value. In *Singer v. Magnavox Co.* the court

⁶⁷ See Aktiebolagslagen (ABL) 10th chapter.

⁶⁸ See for instance ABL 9:31 that stipulates 9/10 majority to change the purpose for the company.

⁶⁹ 262 § DGCL, ABL 14:31

sets for trial to determine whether there was a business purpose for a merger and whether a certain price was a fair price.⁷⁰

The Swedish standpoint on the need for protection of minority owners is that this is an important issue for the legislative process.⁷¹ However, the protection cannot be considered as especially strong, neither in Sweden nor in Delaware; the important difference is that in Sweden the most common ownership shows a dominant owner while the corporate America has a scattered ownership structure. The problem with a dominant majority is more of a European issue than an American one.

6.3 Management

The company president is in charge of management; the board and the auditors control him. The distribution of powers works very much the same under both corporate laws. Neither of the corporate laws stipulates that actually appointing a president is requisite, although this is the most common solution. The president will be answerable, in both cases, to the board that has appointed him. In Delaware the board can be divided into several committees that work with to them assigned issues, thereby allowing the members of a committee to specialise within a certain area.⁷²

In the US, management must always adhere to the “business judgement rule” which governs the fiduciary duties of the management. However, under the DGCL, the board is solely responsible for the management, also regarding the potential misbehaviour of the president. If the president has not properly followed his fiduciary duties he will in his turn be held liable to the board.⁷³ Sweden also stipulates that management has to adhere to its fiduciary duties, though these are very vague.

⁷⁰ *Singer v. Magnavox Co.*, 21. 380 A.2d 969 (Del. 1977)

⁷¹ See for instance the discussion in Rodhe, K. (1999) *Aktiebolagsrätt*, Nordstedts Juridik AB

⁷² See 141§ DGCL on these issues.

⁷³ Johansson, H., Larsson, J. (1996) *Delawares bolagsklimat- En fallstudie av fusionen mellan Pharmacia AB och The UPJOHN Co.*, Faculty of Law, Lund University

Under the business judgement rule, the management must make decision based on the required information in each case, whether it is gathered by a study by their own or by bringing in outside experts. In *Smith v. Van Gorkom*⁷⁴, the Supreme Court of Delaware held that the business judgement rule applied when the managers accepted a proposal for a merger at a large premium over the market price in an arm's-length transaction since the managers did not make an informed decision.

Smith v. Van Gorkom led to quite a change in Delaware law; a provision in the corporate code authorises the companies to eliminate damages liability in duty-of-care cases.⁷⁵ As Easterbrook and Fischel remark, this is an explicit acknowledgement of the role of contract in corporate law. The American Law Institute has recommended following the example of Delaware.⁷⁶

6.4 Protection of Lenders

The stock capital is one of the lenders' measurements of the corporation's worthiness of credit. Naturally, there is no guarantee that the incremental of the corporation keeps its substance, why the regulator tries to create guarantees to that there always is a minimum of assets left in the corporation.

There is great resemblance between the two corporate laws on this matter. Both states have taken the problem into account in their respective corporate law, although the protection of lenders is a very complicated issue that ultimately is regarded by the laws concerning crimes. To fully account for the protection of lenders would take us far outside the scope of this thesis.

⁷⁴ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)

⁷⁵ 102(b)(7)§ DGCL

⁷⁶ Several states have followed Delaware's example. See American Law Institute (Tent. Draft No. 9, 1989) *Principles of Corporate Governance: Analysis and Recommendations* §7.17, as accounted for in Easterbrook, F. H., Fischel, D. R. (1991) *The Economic Structure of Corporate Law*, Harvard University Press

Below I give examples of a few more important rules governing the protection of lenders, as they are dealing with instances when lenders might be disadvantageous.

§ 244 DGCL and ABL chapter six, both concern the reduction of capital, stipulating that no reduction of capital shall be made or effected unless the assets of the corporation remaining after such reduction shall be sufficient to pay any debts of the corporation for which payment has not been otherwise provided.

As another example, subchapter V of the DGCL is dealing with stock and dividends, since payment of dividends is one important instance when lenders might get in an unfavourable position. § 174 is stipulating liability of directors for unlawful payment of dividend, etc, that is payment of dividends when there are not sufficient assets to cover debts. There is a similar construction in the ABL subchapter twelve.

If the corporation acquires its own shares lenders' position might get hurt, why also this manoeuvre is restricted in the corporate laws of Sweden, as well as of Delaware. See ABL chapter seven and § 160 DGCL respectively.

6.5 Anti-takeover Statutes

The Swedish corporate law does not give any means of resistance to hostile takeovers. Delaware, like most US corporate laws, allows several “poison pills” to be taken when threatened by a hostile takeover. Delaware however has waited until recently before it enacted its anti-takeover statute. Some twenty years after the first American anti-takeover statute. It is considered as an innocuous statute and should not be any reason for re-incorporation in Delaware.⁷⁷

⁷⁷ Easterbrook, F. H., Fischel, D. R. (1991) *The Economic Structure of Corporate Law*, Harvard University Press

7 Analysis and Conclusions

7.1 Different Contexts – Different Needs for Regulation

The largest companies favour the corporate law of Delaware but Delaware is not the most popular state in absolute numbers of incorporated companies. For instance the state of California has got many more incorporated companies. Instead, Delaware is a state whereto the largest corporations from all over the United States re-incorporate. My notion is that the newly started companies have issues of more acute nature to address than seeking the optimal corporate structure. Hence, they more likely need a standard contract that is public good, i.e. a corporate law that is tested, easy to find and results in as low transaction costs as possible. The opportunity cost of a transfer to somewhere else would be significantly higher than acceptable for a start-up company.

However, larger companies cannot neglect any aspect of their business, and this is why they might re-incorporate in order to “forum shop”. As the western community gets increasingly deregulated the opportunity costs of a move are decreasing. In the US it is normal for the companies to try to benefit from the variety of corporate laws, and also the EC has somewhat opened the possibility to forum shop thanks to the *Centros*-case. However, the vast difference between the federations is that EC is harmonising the corporate law in Europe. Should a European company for one-or-another reason want to dispose of a regulation it will have to turn to corporate laws outside Europe. Even if the harmonised law, when finally set, should perfectly fit all different companies’ needs. These needs are rapidly shifting and adaptability is therefore of outmost importance. There is no doubt that it is essential for the companies to adapt to their ever-altering prerequisites in terms of Corporate Governance etc.

*“The history of corporations has been that firms failing to adapt their governance structures are ground under by competition.”*⁷⁸

European and American economies are tightly interwoven; so are the two federations’ companies, which find themselves the corporate law “smorgasbord” in the US while the European corporate law market is getting increasingly unyielding. The EC Corporate Law System should better see to the best of the companies’ needs, that is flexible and efficient regulations as well as fast and efficient administration to a low cost, or the wave of re-incorporation in Delaware might well be emanating from Europe in the future.

Not every large company is incorporated in Delaware. How come, if its corporate law and its administration are such efficient institutions every company large enough to be aware of the importance of the corporate law system would incorporate in Delaware, why would they not? The answer to that question is easy. Not all companies are involved in transactions that benefit from a Delaware re-incorporation.⁷⁹ As with machinery, different firms are performing different tasks, which are causing different types of frictions. The companies will organise according to their industry/business prerequisites, underpinning the demand for different types of corporate regulation, and if the corporate law by which they are governed does not go well with them, transaction costs will increase in their effort for circumventing the regulation. The costs of circumventing regulation that does not appeal to one’s desire will be significant irrespectively of whether it is mandatory law or not, however remarkably higher with mandatory regulation than with non-ditto. The companies, rationally acting as *economic men*, would be making a cardinal mistake, not looking at the opportunity cost of circumventing a disliked regulation by re-incorporation.

⁷⁸ Easterbrook, F. H., Fischel, D. R. (1996) *The Economic Structure of Corporate Law*, Harvard University Press, p. 13.

⁷⁹ See Romano, R. (ed.) (1993) *The State Competition Debate in Corporate Law*, in *Foundations of Corporate Law - Interdisciplinary Readers in Law*, Oxford University Press

National boundaries still create in-locks but now, more than ever before, the quest for an optimal corporate regime makes these less fetching to the modern corporation. The corporations will be less attached to a particular nation, in view of the fact that they cannot afford it.

7.2 Institutional Competition in Europe

What would happen if Europe adhered to Institutional Competition? First of all, I do not believe the initial effects to be substantial since I question the incentives for the vast majority of member states to compete. That is, the lack of franchise tax will diminish the intensity of the competition, but not make it disappear.

Secondly, I believe the main issues to be addressed in the case of a European Institutional Competition to be somewhat different from what is the case in the US. I have addressed the issues on shareholder protection and financiers' protection where I see no reason to fear Institutional Competition. Instead, from my point of view the vast difference on the issue of employee participation is the potential driver of competition in Europe.

Also, the diversity in ownership structures call upon a closer look on the minority protection issue. As the US has a scattered ownership structure there has not been a great number of studies on this matter.

However, the European governments agree on the importance of good examples. Although there will not be a competitive situation similar to the one in the USA, "centres of excellence" where the corporate environment is blooming, will naturally draw attention. That is, it will not be the corporate law competition per se that will be predominant but the urge to follow successful approaches, as for instance the Swedish formula regarding IT for some time has been in the international spotlight.

7.3 Is the European Approach detrimental to the Interests of the Corporations?

In order to assess the best way to go, we will have to look on the cost side as well as the benefits of each approach to institutional competition. Looking at the relative advantages of the two approaches I therefore wonder: what will be their costs and benefits?

The corporation, as a judicial form, is benefiting from specialisation; in that way decision-making as well as operation are getting more accurate and swift. As a consequence the organisation adopts according to the type of its particular environment. With a multitude of branches and businesses the variation of a specific *nexus-of-contract* is therefore unimaginable. Different companies have different prerequisites due to that they are in different stages of the maturity cycle, which results in differences of transaction costs' and agent costs' structures. The legislative implication is that altogether there are strong arguments for a corporate law formed as a standard contract, easily adjustable to the needs of the companies so that their different structures can be regarded in the corporate certificate.

The notion of Easterbrook and Fischel, which builds on a radical implementation of the *nexus-of-contracts*, is that *Pareto Superiority* is achieved by leaving to the parties to decide on the legal structure for the company. Most likely the management is best informed on the situation for a specific corporation at any time, and they are in a position for a rapid reaction to change. As already mentioned, the American approach have swung in favour of the notion of Easterbrook and Fischel, while the political process within the European Community gets more and more problematic as more members enrol. The European harmonisation process further bolstering the interests of the establishment instead of nurturing the

innovative processes that is increasingly important to create an attractive corporate environment.

The harmonisation process will not be able to reach a standard contract solution with non-mandatory⁸⁰ legislation that enables the corporations to develop their certificate when so is required.⁸¹ Doing so would have made it possible for the different types of corporations to benefit from a well-tested public good, thus lowering transaction costs. Also, there should preferably be many incorporated companies in order to create a “network-effect” that in conjunction with a highly committed administration secures the evolution of the case law. Instead of trying to create this “optimal” corporate environment the harmonisation will create mandatory rules that cannot protect all shareholders in every corporation. That is because a mandatory rule, which is beneficial to one shareholder in one company, is most likely damaging to shareholders in another company.⁸² Further, the administrative process will be scattered over Europe with a pressured European Court of Justice on top of the pyramid. This cost of adhering to the harmonised European Community should be compared to the opportunity cost of being incorporated under more smoothly running political systems.

It is a contradiction that the protective Europe, fearing the Delaware effect, as it should deregulate the corporate laws of Europe, has an ownership profile with a majority of strong owners in most companies. Arguably, when one or a few owners are dominating a company the monitoring will be more efficient, thereby reducing agency costs, which implies that the main reason for avoiding the Institutional Competition might be void. Agency costs are inherent in the corporate form; never the same investors have been mostly satisfied with the result. Perhaps the Swedish and European strive for

⁸⁰ I want to remind the reader that the European harmonization process results in mandatory regulation of the corporate law. See 5.2.

⁸¹ In a perfect world there would be a corporate law for the start-up, the middle-sized company, the large one as well as for the multinational company, all with competent bureaucracies administrating the companies.

⁸² I.e. the Policy Maker’s Dilemma. See Macey, J. R. (1993) *Svensk aktiebolagsrätt i omvandling*, SNS Förlag

regulation/harmonisation is out of date? The fears of Gary have shown themselves to be exaggerated and the comparison between the Swedish “protective state intervention”, and Delaware’s “laissez-faire” corporate laws showed that the difference is not as vast as imagined. The fear of the *Delaware effect* seems caused by the anticipation of a situation with non-existing regulation of corporate issues and intense tax competition. In this context issues such as shareholder protection against management is often mentioned. However, the greatness of Delaware is not due to neither low tax pressure nor a “deregulated” corporate law. The success is much attributed to the highly professional and determined administration that daily address high-levelled corporate issues.

Most scholars, not to mention practitioners, have realised that the possibly opportunistic behaviour from management is to great extent controlled by alternative means beside legislation. Namely, there are much stronger forces than a slowly evolving governmental regulation. For instance, the mere threat of take-overs, in conjunction with the power of the market for corporate management, or preferably, a sound incentives program that secures the alignment of the management’s interests with the shareholders. This is called *the Invisible Hand*; the dynamics of the market drive the managers to act as if they had investors’ interest at heart. Moreover, would financiers still do not feel comfortable they could always demand to be left further security.

The European approach is not chosen after thoughtful consideration; rather, it is a result of premature thinking in fear of an effect that concerned American scholars in the seventies. Since the study of Gary the American debate has turned in favour of the competition. By harmonising we mandate a floor, thereby severely reducing returns from innovation, and correspondingly, from competition.⁸³

⁸³ See Romano, R. (1993) *The Genius of American Corporate Law*, The AEI Press

The American shift in point of view is based on several event studies showing increased shareholder value on re-incorporation to Delaware. Instances as when management's responsibility was limited have showed increased stock prices, which is exactly the other way around to what the European approach would suggest.

The solution with a non-mandatory standard contract will gain momentum the closer to perfectly informed markets we come. Experts, making small shareholders "free-riders" as this information will show in a more accurately priced stock without them bearing the costs of the evaluation, will evaluate any adjustment to the standard contract.

Finally, it is in the best interest of the shareholders to solidly protect the lenders in the articles of association, why there is no need for a mandatory regulation; if the corporation does not see to protect the financiers their cost of capital will increase, which would be devastating to the corporation. That is, parties that freely may contract will find the most efficient agreement. If, for instance a clause on a certain protection of the lender is worth more to the lender than it costs the corporation, it will be in the loan contract. If it costs more to the corporation than it is worth to the lender, it will correspondingly not be in the loan contract. A principal conclusion is that the harmonisation hinders the contractual freedom of the corporation and its financiers, which probably increases the transaction costs. However, the transaction costs occurring when the parties contract entirely on their own must always be compared to the transaction costs inflicted on the parties by a corporate law regulation. There are always three ways to go: the corporate law, the by-laws or contract. In order to reach the most efficient solution, the question is how do we strike the balance between regulation and party autonomy?

7.4 The Harmonisation Process's Many Stakeholders

However, the main purpose of the harmonisation is not to maximise shareholder value but to increase the free movement of capital, services, goods and people within the European Community. That is, there are several groups that might benefit from harmonisation over institutional competition. In this respect, might institutional competition become a hindrance to the free movement of capital? If so, can harmonisation be said to proliferate the investors by minimising information costs? I am not quite sure about that. Since the large corporations are constantly scrutinized by professional analysts, which means that the many investors and lenders will not increase their costs of seeking information due to a re-incorporation. Capital market is very well informed all over the European Community, why different corporate laws will not much alter the cost of information seeking for the average investor.

Although the objective is to increase the free movement there is no agreement on the harmonisation process's goal. The scope is unclear, for instance the 54th article in the Treaty says no more than that harmonisation shall take place only when called upon. The European approach of harmonisation is to mandate a floor for the corporate law. This process is the outcome of a political process where the corporate law development is secondary to the integration of the European Community. In order to reach agreement of any kind the interaction is intense under a long period of time.

Also of great importance is the strong European stakeholder perspective that is predominant in Europe, in opposition to the American shareholder perspective on the corporation. Arguably the unions have had strong influence over the European corporate law.

As politics is one of several macro factors the multinational companies try to control lobbying probably is equally intense as the negotiations on the

political arena. Europe, with its many relatively small countries that all have votes in the EC “stipulating process” offers many opportunities for different lobbying groups. Cynics could argue that the harmonisation process thus favours the establishment. The reasoning behind this statement rests on several factors. Only few, large companies have in-roads to the political process at the Community level. Further, no one represents the wide spectrum of smaller businesses and the outcome of the legislative process should therefore be in favour of the demands of the established multinationals, instead of following the needs of more innovative start-ups. Thereby reduces the likeliness of returns that come from competition. As competition breeds innovation, the effect from reducing competition will correspondingly affect the plausibility of return from innovation.

Even when there is consensus on the policy objective there is an obvious risk of the long-lasting legislative process to cause in-locks for the once mandated regulation and thereby making possibilities for changes extremely difficult. With two diametrically different law cultures within the Community, changes are difficult to accomplish. Due to excessive transaction costs intergovernmental co-ordination raises the costs of implementing public policy, i.e. when changes of vast importance are to be made, the restructuring will take time to accomplish. There is an obvious danger of creating a rigid European corporate law structure. Concisely, in the long run no one probably benefits from the harmonisation process; neither the established major corporations nor the small start-ups.

The one big likely benefit of harmonisation for the corporations would arguably be that harmonisation would ease the establishment in a secondary state as well as a move across the Community. Possibly production resources would effortlessly be exploited if *siège réel* rule would not be applied. The *Centros*-case has probably already changed these obstacles against free establishment. Moreover, several countries are already to some extent supporting re-incorporation.

7.5 In Conclusion

In a longer perspective, harmonisation is probably not beneficial to the corporate environment. It creates opportunities for the establishment, by lobbying, to hinder the evolution of the corporate law system. In most cases it is an old truth that competition creates a better soil for returns from innovation as well as it increases the probability of efficiency in the administration. What is beneficial to the large corporations in the short run might hit back on them, as the returns from innovation will be limited in the long run. Moreover, different industries give over time continuously changing prerequisites for the corporations to address, implying that at every instance there are different needs when it comes to corporate law.

The incentives for EC member states to compete on their corporate laws are limited due to the fact that we do not have franchise taxes in Europe. Lessons from the US tell us that competition does not de-regulate the corporate law environment, instead it proliferates the member state's corporate laws and forces the administrations to be at their toes, thereby reducing transaction costs for the corporations. In a European corporate law context, we should not fear the Institutional Competition. The incentives to compete in a damaging way are much larger in the taxation arena. Instead I believe "centres of excellence" to be copied, creating a positive competition, meaning that good examples are being followed. Institutional competition would probably proliferate "best practises" under these circumstances.

There is no vast difference between Delaware's and Sweden's corporate law, as to the protection of shareholders. As several event studies suggest the fear of the Delaware effect is therefore exaggerated. The protectionists argue that we risk losing control over the protection of shareholders. However, in general the Invisible Hand keeps management in place, and when it comes to minority protection, which could easily be dealt with in contract, I see no obstacle to letting the member states stipulate the corporate law by themselves. Being scrutinized all the time, the corporations

can probably take care of much of the work that nowadays is made by regulation. The close to perfectly informed market would sanction the outcome of their efforts.

Irrespective of whether one favours Institutional Competition or not, it is compromising that there is neither a goal for the harmonisation process, nor a discussion of whether harmonisation should prevail over Institutional Competition. Moreover should we harmonise to truly proliferate the life of our corporations we could as well realise that the corporate arena nowadays is global. Perhaps Europe should lobby for a worldwide agreement on the corporate law structure? After all, Europe can already be considered a competitor to the state of Delaware in a global corporate environment context.

I strongly believe Institutional Competition with the ability to forum shop could make European corporations benefit from *Network Effects*, i.e. when a member state has a well-developed corporate law, it will receive many incorporations and thus will more companies realise the advantages of the corporate law, and so forth. The corporate law will be tested, further evolving, and in that way it continues to develop over time, ever decreasing transaction costs as it responds to market demand. (Compare to computer software development, e.g. Microsoft Windows.) In the same way, the administration in successful states gains experience making it a more smooth bureaucracy to be dealing with. In that way transaction costs are limited for the corporations.

Finally, governance structures can be seen as a mechanism for making decisions that have not been specified in the initial contract. It is important to stress that the best-informed parties most likely are in the most favourable position to set that structure, and thereby keep transaction costs at bay. I daresay that politicians are far from being in such position.

Appendix

Definitions

“**Investors**” and “**financiers**” are used synonymously, thereby occasionally including “creditors” in the essence of these expressions.

“**Certiorari**”: “A writ, issuing from a superior court, upon the complaint of a party that he has not received justice in an inferior court, or cannot have an impartial trial, by which the records of the cause are called up for trial in the superior court.”

“**Franchise tax**” is a “location tax” that is often calculated on the basis of the number of shares of authorised capital stock. I.e. unrelated to the profit of the corporation. It is paid to the state of incorporation irrespective of whether there is any economic activity carried out in the state or not.

“**Fraud on the law**” is the same as trying to circumvent statutes in the corporate law. See for instance *Centros Ltd. v. Ehrvervs- og Selskabsstyrelsen*, Case C-212/97, [1999] ECR I-1459 -case.

“**Incorporation**”: All shareholders, promoters and others, will have been informed of the state of incorporation when the shares have been offered for prescription. That is, prior to any investment have been made they can inform themselves of the corporate law and its issues.

“**Re-incorporation**”: On this event the corporation will no longer be subject to the law prescribed when it was incorporated, but it will be chartered under another state, which corporate law will now be applicable.

Franchise tax

“Siège réel”: most European nations follow the law of a company’s real or effective seat (siège réel) rather than of statutory domicile, i.e. registered office.

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